82-1369

No. 82-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

WESTERN COAL TRAFFIC LEAGUE, THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE, AMERICAN PAPER INSTITUTE, INC., CENTRAL ILLINOIS LIGHT COMPANY, MIDDLE SOUTH UTILITIES SYSTEM, POTOMAC ELECTRIC POWER COMPANY, PUBLIC SERVICE COMPANY OF INDIANA, INC., SOUTH CAROLINA PUBLIC SERVICE AUTHORITY, NEVADA POWER COMPANY, AND AMERICAN IRON AND STEEL INSTITUTE,

Petitioners,

v.

UNITED STATES OF AMERICA AND INTERSTATE COMMERCE COMMISSION,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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February 14, 1983

QUESTIONS PRESENTED

Under the Interstate Commerce Act, revenue adequacy is a concept of paramount importance in the area of maximum rail rate regulation. Rail carriers with inadequate revenues are entitled to certain extraordinary rate freedoms and special considerations to which financially-healthy carriers are not.

In the decision below, the Court of Appeals affirmed a decision of the Interstate Commerce Commission ("ICC" or "Commission") establishing revenue adequacy standards under Section 10704(a)(2) of the Act. The ICC decision held that a) the only standard which should be applied in determining carrier revenue adequacy under Section 10704(a)(2) is whether a rail carrier is earning a rate of return on its net investment base equal to the current cost of capital; and that in applying this standard, b) the presence of unused and nonuseful property in the net investment base could be ignored; c) deferred taxes should be included in the net investment base; and d) the cost of the carriers' debt should be calculated not on the basis of their actual historical interest expenses, but on the basis of the interest which would attach if all debt were issued today, at current rates.

This ICC decision reversed earlier Commission decisions which squarely held that the agency could not, consistent with the statutory definition of revenue adequacy, rely solely on the rate of return standard in determining the adequacy of carrier revenue levels. Under this new standard there are no Class I railroads in the United States which are considered revenue adequate by the ICC.

The question presented is whether the Court of Appeals erred in affirming the ICC's new revenue ade-

quacy standard or the ICC's subsidiary rulings concerning the composition of the net investment base and the cost of debt.

PARTIES TO THE PROCEEDINGS BELOW

The parties to the proceeding below were: Western Coal Traffic League; National Industrial Traffic League; Edison Electric Institute; Chemical Manufacturers Association; American Paper Institute, Inc.; American Iron and Steel Institute; Iowa Power & Light Company; Iowa Electric Light and Power Company; Oklahoma Gas & Electric Company; Southwestern Electric Power Company; Central Illinois Light Company; Middle South Utilities System; Arkansas-Missouri Power Company; Arkansas Power & Light Company; Louisiana Power & Light Company; Mississippi Power & Light Company; New Orleans Public Service, Inc.; Potomac Electric Power Company; Public Service Company of Indiana, Inc.; South Carolina Public Service Authority; Carolina Power & Light Company; South Carolina Electric and Gas Company; Virginia Electric and Power Company; Alabama Power Company; Georgia Power Company; Gulf Power Company; Mississippi Power Company; Southern Company Services, Inc.; Nevada Power Company; Bessemer and Lake Erie Railroad Company and Association of American Railroads.

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OPINIONS BELOW

The opinion by the Court of Appeals is reported as *Bessemer and Lake Erie Railroad Company* v. *Interstate Commerce Commission and United States of America*, 691 F.2d 1104 (3rd Cir. 1982) (App. to Cert. Petn. A). In its opinion, the Court of Appeals affirmed a decision issued by the Interstate Commerce Commission and reported as Ex Parte No. 393, *Standards for Railroad Revenue Adequacy*, 364 I.C.C. 803 (1981). (App. to Cert. Petn. B).

JURISDICTION

The Court of Appeals' opinion was filed on October 19, 1982. Timely petitions for rehearing were filed. These petitions were denied by the Court of Appeals on November 15, 1982. (App. to Cert. Petn. C). On December 3, 1982, the Court of Appeals issued its certified judgment, in lieu of a formal mandate. (App. to Cert. Petn. D). A petition to recall the mandate was denied on January 25, 1983. (App. to Cert. Petn. D). Jurisdiction of this Court arises under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS

The Court of Appeals affirmed the Interstate Commerce Commission's construction of Section 10704(a)(2) of Subtitle IV, Title 49, United States Code (hereinafter "Interstate Commerce Act"), 49 U.S.C. § 10704(a)(2). Section 10704(a) provides, in pertinent part:

> (2) The Commission shall maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers providing transportation subject to its jurisdiction under that subchapter that are adequate, under honest, economical, and efficient management, to cover total operating expenses, including depreciation and obsolescence, plus a reasonable and economic profit or return (or both) on capital employed in the business. The Commission shall make an adequate and continuing effort to assist those carriers in attaining revenue levels prescribed under this paragraph. However, a rate, classification, rule, or practice of a rail carrier may be maintained at a particular level to protect the traffic of another carrier or mode of transportation only if the Commission finds that the rate or classification, or rule or practice related to it, reduces or would reduce the going concern value of the carrier charging the rate. Revenue levels established under this paragraph should—

(A) provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation; and

(B) attract and retain capital in amounts adequate to provide a sound transportation system in the United States.

(3) The Commission shall conclude a proceeding under paragraph (2) of this subsection within 180 days after the effective date of Staggers Rail Act of 1980 and thereafter as necessary.

(4) On the basis of the standards and procedures under paragraph (2) of this subsection, the Commission shall, within 180 days after the effective date of the Staggers Rail Act of 1980 and on an annual basis thereafter, determine which rail carriers are earning adequate revenues.

STATEMENT OF THE CASE

In 1976, Congress added a provision to the Interstate Commerce Act which required the ICC to hold a hearing and promulgate, by February, 1978, standards and procedures for determining carrier revenue adequacy. Railroad Revitalization and Regulatory Reform Act of 1976 ("*4-R Act*"), Pub. L. No. 94-210, § 205, 90 Stat. 41. This new section of the law, now codified at 49 U.S.C. § 10704(a)(2),[1] established various financial criteria that the ICC should consider in determining whether a rail carrier was revenue adequate.

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[1] What is now § 10704(a)(2) was originally codified at 49 U.S.C. § 15a(4). In 1978, Title 49 of the United States Code was recodified, without substantive change. Pub. L. No. 95-473, 92 Stat. 1337. *See* Chicago & North Western Transp. Co. v. Kalo Brick & Tile Co., 450 U.S. 311 (1981). Under this recodification, § 15a(4) became § 10704(a)(2).

In 1978, after conducting the Congressionally mandated rulemaking proceeding, the ICC issued a comprehensive decision promulgating standards and procedures for determining carrier revenue adequacy. Ex Parte No. 338, *Standards and Procedures for the Establishment of Adequate Revenue Levels*, 358 I.C.C. 844, *modified* 359 I.C.C. 270 (1978) ("*Ex Parte No. 338*"). Those standards, codified at 49 C.F.R. § 1109.25 (1978), provided for consideration of "all pertinent financial indicators" in determining whether a rail carrier was revenue adequate. *Id.*, § 1109.25(a)(1). The ICC first applied its *Ex Parte No. 338* standards and procedures in Ex Parte No. 353, *Adequacy of Railroad Revenue (1978 Determination)*, 362 I.C.C. 198 (1979) ("*Ex Parte No. 353*"). In this decision, the ICC found, based upon an evaluation of all relevant financial data, that 13 of the 36 Class I railroads then operating in the United States were revenue adequate. *Id.*, 362 I.C.C. at 256-57.

In both *Ex Parte No. 338* and *Ex Parte No. 353*, the ICC ruled that it would take into consideration the revenue adequacy status of individual rail carriers in determining whether individual rail rates should be syspended or investigated, and whether individual rates were reasonable. *Ex Parte No. 338*, 358 I.C.C. at 854; *Ex Parte No. 353*, 362 I.C.C. at 277-79. The Commission applied these principles in individual rate cases by sanctioning higher rates on traffic carried by "revenue inadequate" carriers. *See, e.g., Cleveland-Cliffs Iron Co.* v. *ICC*, 664 F.2d 568, 587 (6th Cir. 1981); *Burlington Northern Inc.* v. *United States*, 661 F.2d 964, 973-74 (D.C. Cir. 1981); *Celanese Chemical Co., Inc.* v. *United States*, 632 F.2d 568, 576 (5th Cir. 1981), *cert. dismissed*, ___ U.S. ___, 102 S.Ct. 27 (1981); *System Fuels, Inc* v. *United States*, 642 F.2d 112, 116 (5th Cir. 1981); *San Antonio, Texas* v. *United States*, 631 F.2d 831, 848-50 (D.C. Cir. 1980).

After *Ex Parte No. 353*, the ICC issued two additional decisions which calculated the railroads' cost of capital for the years 1979 and 1980 (Ex Parte No. 363, *Adequacy of Railroad Revenue (1979 Determination)*, 362 ICC 344 (1979); Ex Parte No. 381 *Adequacy of Railroad Revenue (1980 Determination)*, 364 I.C.C. 311 (1980)). However, it made no subsequent determinations, after *Ex Parte No. 353*, of revenue adequacy on a carrier-by-carrier basis, indicating that it was considering proposing revisions to its standards.

In October, 1980, Congress enacted the Staggers Rail Act of 1980 ("*Staggers Act*"), Pub. L. No. 96-448, 94 Stat. 1895 (1980). During Congressional consideration of this law the railroad industry, displeased with the standards for determining revenue adequacy adopted by the ICC in *Ex Parte No. 338* and applied in *Ex Parte No. 353*, endeavored without success to have the statutory definition of revenue adequacy amended to provide that the sole standard of revenue adequacy would be a rate of return on net investment equal to the current cost of capital.[2] The *Staggers Act* made substantial changes in other sections of the Interstate Commerce Act, but it left the definition of revenue adequacy unchanged and made only one technical correction in Section 10704(a)(2) itself.[3] While Congress did not alter the definition of carrier revenue adequacy, it did codify the ICC's administrative

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[2] This had consistently been the carriers' position, and was the position rejected by the ICC in Ex Parte Nos. 338 and 353.

[3] Section 205 of the 4-R Act had specified that the ICC could "revise and maintain" its revenue adequacy standards and procedures. *Id.* The word "revise" was deleted from the text of Section 205 when the law was recodified as Section 10704(a)(2). In the Staggers Act, Congress reinserted language providing that the ICC could "revise as necessary" its revenue adequacy standards. *Id.*, § 205(b)(1), 94 Stat. 1906.

practice of considering the revenue adequacy status of a rail carrier in rate suspension, investigation and reasonableness determinations, and utilized revenue adequacy as a means for determining when carriers should be entitled to certain new rate freedoms.[4] Finally, concerned about the ICC's failure after *Ex Parte No. 353* to make annual revenue adequacy determinations, Congress added Sections 10704(a)(3) and 10704(a)(4) to the Interstate Commerce Act, requiring the ICC to conclude a proceeding under Section 10704(a)(2) "within 180 days after the effective date of the Staggers Rail Act of 1980 . . ." (Section 10704(a)(3)), and to make a determination of which rail carriers were earning adequate revenues within the same 180 day period and each year thereafter. 49 U.S.C. § 10704(a)(4).

The Commission responded to the *Staggers Act* directives by instituting a rulemaking proceeding it denominated Ex Parte No. 393, *Standards For Railroad Revenue Adequacy* ("*Ex Parte No. 393*") (Notice of Proposed Rulemaking, 45 Fed Reg. 80150, Dec. 3, 1980). Comments were filed by a large number of interested parties, and the ICC's final order was served on March 26, 1981. Therein, in a five member decision including one concurring and one dissenting opinion, the ICC reversed its *Ex*

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[4] *See* Staggers Act § 201(a), adding 49 U.S.C. § 10701a(b)(3) (ICC to consider its Section 10704(a)(2) revenue adequacy findings "[i]n determining whether a rate established by a rail carrier is reasonable. . . ."); Staggers Act § 203(a), adding 49 U.S.C. § 10707a(d) (revenue inadequate rail carriers permitted to take designated rate increases which cannot be suspended by the ICC) and adding 49 U.S.C. § 10707a(e) (ICC to consider Section 10704(a)(2) findings in specified complaint and investigation proceedings); Staggers Act § 217, adding 49 U.S.C. § 10705a (revenue inadequate rail carriers permitted to take specified rate surcharges not available to revenue adequate carriers).

Parte Nos. 338 and *353* decisions by holding that it would no longer consider all available financial evidence in determining whether a carrier was revenue adequate. It proposed instead to make revenue adequacy determinations solely on the basis of whether a rail carrier is earning a rate of return on its net investment base equal to the current cost of capital for the railroad industry, as determined by the ICC. *Id.*, 364 I.C.C. 803, 821 (App. to Cert. Petn. B-13-19). In so holding, the ICC also ruled (1) deferred taxes should be included in the net investment base (*id.*, 364 I.C.C. at 814) (App. to Cert. Petn. B-12); (2) unused and nonuseful assets need not be excluded from the net investment base (*id.*, 364 I.C.C. at 811) (App. to Cert. Petn. B-11); and (3) carrier debt costs should be calculated as though all carrier debt were paying current interest rates, rather than on the basis of the amounts actually being paid by the railroads for interest expenses. *Id.*, 364 I.C.C. at 816 (App. to Cert. Petn. B-14). Using this new standard, only three atypical carriers out of thirty-six Class I railroads were found revenue adequate. *Id.*, 364 I.C.C. at 826 (App. to Cert. Petn. B-24). This number has since dwindled to zero under the ICC's most recent revenue adequacy determination. Ex Parte No. 439, *Railroad Revenue Adequacy—1981 Determination* (Decision served Nov. 18, 1982) (unprinted).[5]

Petitions for review of the ICC's *Ex Parte No. 393* decision were filed under 28 U.S.C. §§ 2321 and 2345 by numerous concerned shipper organizations, representing thousands of individual rail shippers. Most of these shippers are utilities or businesses who are dependent upon the railroad industry to ship bulk commodities such as

[5] The Fort Worth and Denver Railroad and the Clinchfield, the only two carriers which were found revenue adequate in Ex Parte No. 439, no longer exist because they have both been merged into larger parent railroads.

coal, iron ore, chemicals, and pulpwood. This bulk traffic is captive to the rail industry, and in recent years railroads have aggressively attempted to raise rates on this traffic in order to promote their "revenue adequacy." The railroad industry also filed a limited challenge to the ICC's order but, as a whole, the industry supported the ICC's order and the industry's chief spokesman, the Association of American Railroads, intervened in support of the Commission.

Before the Court of Appeals, shipper-petitioners filed extensive briefs describing, in detail, how the ICC's *Ex Parte No. 393* order constituted an abrupt, unreasoned and erroneous departure from its previous, and correct, interpretation of Section 10704(a)(2). They also explained that because of the importance of revenue adequacy considerations in the ICC's determination of maximum reasonable rail rates, the truly massive gap between the railroads' existing earnings and those deemed necessary to achieve adequate revenues under the Commission's new standard would effectively deprive captive rail shippers of any maximum reasonable rate protection, as well as frustrate other important goals of the Interstate Commerce Act.

In a decision issued some three weeks after oral argument, the Court of Appeals affirmed the Commission's decision in all respects. It found that the overall policies pursued by the agency were consistent with the directives of the Congress in the relevant statutory provisions. Subsequent petitions for rehearing and rehearing en banc, and for recall of the court's mandate[6] were denied. (App. to Cert. Petn. C, E).

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[6] The case was decided by a panel consisting of one circuit court judge and two district court judges. A petition to recall the court's mandate was filed by certain petitioners on the grounds that under a recent amendment to 28 U.S.C. § 46(b) the case should have been

REASONS FOR GRANTING THE WRIT

I.

THIS PETITION RAISES CRITICAL QUESTIONS CONCERNING THE PROPER ADMINISTRATION OF THE RATEMAKING PROVISIONS OF THE INTERSTATE COMMERCE ACT

In the *4-R Act*, Congress completely freed from ICC maximum rate regulation all rates on competitive rail traffic.[7] For "captive" rail traffic, however, Congress recognized the need for continuing government regulation in order to protect shippers against exorbitant prices. This regulatory scheme was maintained in the *Staggers Act*.

The practical effect of the new ICC revenue adequacy standards, affirmed by the court below, will be to deprive captive rail shippers of the maximum rate protections which Congress intended them to have. It does this by relying upon an artificial and unrealistic measure of a railroad's financial health, under which the "shortfall" between existing earnings levels and "adequate" earnings levels is so immense that the Commission cannot

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heard and decided by a panel including at least two circuit court judges. This petition was denied by the court with an opinion explaining that only one judge on the Third Circuit was eligible to hear the case. (App. to Cert. Petn. E.). It would thus appear that the petition for rehearing en banc was decided by a single judge.

[7] This was done through adoption of the "market dominance" jurisdiction standard. 49 U.S.C. § 10709. The purpose of the 4-R Act market dominance standard is to deregulate rail rates in markets where carriers face transportation competition, but leave regulation in place where carriers retain monopolistic pricing power over particular traffic segments. Western Coal Traffic League v. United States, 694 F.2d 378 (5th Cir. 1982); Atchison, T. & S.F. Ry. v. ICC, 580 F.2d 623, 636-37 (D.C. Cir. 1978). By and large, the traffic subject to continuing ICC regulation includes heavy loading commodities such as coal, chemicals and other bulk commodity descriptions for which railroads provide the only feasible mode of transportation.

reconcile the two statutory goals of assisting the carriers to achieve revenue adequacy and maintaining reasonable rate levels on captive traffic.

Under the Interstate Commerce Act, the Commission must take into account the adequacy of a carrier's revenues as determined under Section 10704(a)(2) in determining whether rail rates filed by carriers are reasonable. 49 U.S.C. § 10701a(b)(3). In addition, a carrier's eligibility for certain special procedural protections against challenges to rate increases is determined on the basis of revenue adequacy. 49 U.S.C. § 10707a(d). Thus, the Commission's revenue adequacy determinations made under Section 10704(a)(2) will affect virtually every rail ratemaking decision over which the ICC exercises its regulatory jurisdiction.

Given the broad application of the Commission's Section 10704(a)(2) findings in establishing rail rates, it is of the utmost importance that the standards and procedures that the Commission uses to determine which railroads are or are not revenue adequate, and the sums they need to obtain revenue adequacy, be determined in accordance with the directions given by Congress in Section 10704(a)(2). To the extent that the Commission has erroneously interpreted its Section 10704(a)(2) mandate, the mistake becomes magnified hundreds or thousands of times as the Commission applies its erroneous standard in the ratemaking cases brought before it by concerned shippers.

The linkage between revenue adequacy and maximum ratemaking policy is very strong and direct. For the past several years, the ICC has been endeavoring to formulate rational and consistent standards for determing maximum rail rates for coal transportation, the largest body of captive traffic, in a proceeding known as Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines—Nationwide*. Af-

ter considering the implications of the Commission's new revenue adequacy standards in connection with the development of those ratemaking guidelines, however, the ICC staff concluded that "[a] politically and socially acceptable maximum rate policy cannot accomplish the revenue adequacy measure defined in Ex Parte No. 393."

Although the Commission has been refraining from deciding maximum rail rate cases while it endeavors to complete development of its new ratemaking guidelines, its decisions in the few cases it has been forced to decide under statutory deadlines have established that it views revenue adequacy considerations as preeminent and overriding factors in determining whether rail rates are too high. In a series of cases involving appeals by railroads under 49 U.S.C. § 11501(c) from decisions of state agencies prescribing maximum reasonable rate levels on intrastate traffic, the Commission has rejected the states' determinations on the ground that the states have failed to reflect sufficient consideration of the carriers' revenue needs. Docket No. 38793, *Petition For Review Of A Decision Of The Public Service Commission Of West Virginia*, (Decision served March 18, 1982), appeal docketed No. 82-3122, *Wheeling-Pittsburgh Steel Corporation* v. *ICC, et al.* (3rd Cir.); Docket No. 38809, *Louisville & Nashville—Petition To Review Decision Of Kentucky Railroad Commission*, (Decision served April 15, 1982), appeal docketed No. 82-3312, *Kentucky Utilities Co., et al.* v. *United States, et al.* (6th Cir.); Docket No. 38946, *Petition Of Louisville & Nashville Railroad Co. For Review Of A Decision Of The Public Service Commission Of Indiana*, (Decision served November 24, 1982), appeal docketed No. 82-2399, *Public Service Company of Indiana, Inc.* v. *United States*, (D.C. Cir.).

In one of these cases, Docket No. 38809, *supra*, the Commission described the role of revenue adequacy considerations in ratemaking as follows:

> [T]he unequivocal mandate of Congress in the Staggers Rail Act of 1980 is promotion of revenue adequacy. . . . Thus, revenue adequacy must be a key consideration in every rate reasonableness proceeding.

Id., at sheet 7. On the basis of the Commission's increasing emphasis on revenue adequacy in these recent cases, an ICC administrative law judge has held that "[u]ntil the carriers are revenue adequate as determined by the ICC no rate in this Judge's opinion can be found to be above a maximum reasonable level." Docket No. 37801S, *Aluminum Company of America* v. *Bauxite & Northern Railway Co.*, (Decision served December 21, 1982).

Not only do the ICC's new revenue adequacy standards subvert maximum rate regulation by establishing an unfair and unreasonable goal which rate regulation policy must then attempt to achieve, they deprive the concept of revenue adequacy of any meaning as a standard for differentiating between financially weak and strong carriers. As a result, the Congressional design that revenue adequacy serve as a triggering mechanism for certain extraordinary procedural ratemaking devices[8] has been entirely defeated.

Under the new standards, railroads such as the Southern Railway and the Union Pacific, which are widely regarded in the business and financial communities as financially solid and prosperous companies, are viewed as being far removed from the goal of revenue adequacy. Similarly, a carrier such as the Burlington Northern Railroad, which on the basis of the Commission's new stand-

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[8] See fn. 4, *supra*.

ard of revenue adequacy appears to be on its last legs, is described by the financial press as a "cash cow,"[9] able to throw off sufficient cash from its operations to enable its parent to acquire El Paso Natural Gas Company for some $600 million.[10]

Some of the specific errors in the Commission's decision are described, *infra*, but the stark contrast between the results obtained under the new revenue adequacy standard and the real world is reflected in the fact that an ICC staff survey of major railroad financial analysts concluded that "there was a unanimity of views" that "[n]o single ratio should be employed as the sole determinant of revenue adequacy."[11] Indeed, most of the analysts surveyed indicated that they would not even consider return on investment as an indicator of revenue adequacy.[12]

Results such as those obtained under the revenue adequacy standards adopted in *Ex Parte No. 393* are clearly not what Congress envisioned when it enacted Section 10704(a)(2). Congress intended that the ICC administer this law in such a way as to make a meaningful distinction between financially strong and weak railroads, and then to apply these rational findings in carrying out its ratemaking duties under the Interstate Commerce Act. The ICC, with the approval of the Court of Appeals, has devised a standard of carrier revenue adequacy that does not comport in any respect with the Congressional mandate it was created to meet.

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[9] *See Business Week*, March 8, 1982, at 112-113.

[10] *The Journal of Commerce*, February 9, 1982, at 2A.

[11] This memorandum was brought to the attention of the lower court, and included in the administrative record. *See* Motion to Supplement Record Filed by Nevada Power Co. on April 26, 1982 at Appendix A, p. 6.

[12] *Id.*

II.

IMPORTANT QUESTIONS OF FEDERAL LAW APPLICABLE IN ALL PROCEEDINGS UNDER THE INTERSTATE COMMERCE ACT WERE WRONGLY DECIDED BY THE COURT BELOW

A. Section 10704(a)(2) Expressly Precluded The Commission From Relying Upon The Return On Investment Test As The Sole Measure Of Railroad Revenue Adequacy

Prior to its *Ex Parte No. 393* decision, the ICC had never relied upon return on investment data as the sole measure of rail carrier financial health. As stated by the Coordinator of the ICC's massive pre-*4-R Act* study of rate base/rate of return ratemaking in the rail industry, "[r]ate of return on net investment . . . has never been used as a sole criterion of revenue need." Ex Parte No. 271, *Net Investment—Railroad Rate Base and Rate of Return*, 345 I.C.C. 1492, 1565 (1976). The principal and long recognized problem with using a rate base/rate of return standard for railroads is that their rate base is not regulated, and the "used and useful" character of significant portions of this base has been called into serious question. *See, e.g., id.* at 1521. Because of these and other problems, the ICC traditionally supplemented rate of return data with many other "financial data." *Id.*, 345 I.C.C. at 1565.

Congress was fully aware of this situation when it enacted Section 10704(a)(2) in 1976. Under the statute, revenue levels were to be evaluated not only in terms of whether they provided a "reasonable . . . return . . . on capital employed in the business," but also in terms of whether they provided a "flow of net income . . . adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital and cover the effects of inflation." 49 U.S.C. § 10704(a)(2). It was also required that

the Commission determine whether conditions of "honest, economical and efficient management" existed. *Id.*

In the Senate Report accompanying its version of Section 10704(a)(2), the Senate took pains to stress that railroad revenue adequacy could not be evaluated solely by reference to a return on investment standard:

> Previous analysis of the adequacy of regulated industry revenues has focused upon adequate returns on investment. While this type of analysis may need to be continued, *it is equally important* for the Commission to focus on the level of revenue needed to provide and maintain adequate service in the public interest. This requires emphasis upon present and future revenue levels under honest, economical and efficient management *as opposed to a theoretically adequate rate of return on investment* that may have no relationship to the need for operating and capital funds necessary to maintain service in the public interest."

S. Rep. No. 94-499, 94th Cong. 2d Sess. 51-52 (1975) (emphasis supplied). The Senate Committee's language could not have been more direct. As one standard among others, return on investment could be reasonably considered. But it could not be "consecrated" as the sole and exclusive criterion of revenue adequacy.

Because Congress did not want the ICC to rely exclusively upon "theoretically adequate rate of return on investment" data, and instead intended that the ICC consider and weigh other financial indicators, it wrote a statute in broad terms requiring the Commission to look to all relevant financial evidence. A Memorandum prepared by the ICC's staff itself in 1980 illustrates in graphic detail the spectrum of financial evidence—in addition to rate of return data—which was called for under the statute's definition of revenue adequacy:

Requirements of Title 49 Section 10704(a)(2) of U.S. Code	Appropriate Financial Ratio
1. Cover total operating expenses, including depreciation and obsolescence.	*Operating Ratio
2. Provide a reasonable and economic profit or return (or both) on capital employed in the business.	*Return on Investment (ROI) *Return on shareholders' equity (ROE) *Return on total capitalization (ROTC)
3. Provide a flow of net income plus depreciation adequate to support prudent capital outlays.	*Percentage of increase in net transportation investment
4. Assure repayment of a reasonable level of debt.	*Throw-off-to debt ratio (TOTD) *Fixed charges coverage ratio (FCC)
5. Permit raising of needed equity capital.	*Return on shareholders' equity
6. Cover effects of inflation.	*Comparison of ROI to cost of capital
7. Attract and retain capital in amounts adequate to provide a sound transportation system.	*ROI, ROE, ROTC and dividend payout ratio

(Memorandum by Acting Chief, Section of Financial Analysis, I.C.C. to Director of Financial Analysis, Dated May, 1980).[13]

Analysis of the text and legislative history of Section 10704(a)(2) demonstrates Congress' intention to preclude the ICC from relying solely upon a rate base/rate of return standard in measuring the adequacy of railroad revenues. Support for this conclusion also comes from *San Antonio, Texas* v. *United States*, 631 F.2d 831, 850 n.104 (D.C. Cir. 1980), in which the D.C. Circuit recog-

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[13] See fn. 11, *supra*.

nized that Section 10704(a)(2) "does indicate that the Commission should not focus solely on a rate of return analysis but instead should adopt a prospective view of carrier revenue needs."

In revenue adequacy proceedings prior to *Ex Parte No. 393*, the Commission itself acknowledged that Section 10704(a)(2) prohibited exclusive reliance upon a single measure of revenue adequacy. In its Notice of Proposed Rulemaking in *Ex Parte No. 338*, the Commission stated clearly that—

> Section [10704(a)(2)] does not envision that the rate of return will be the sole factor to be considered in judging carrier revenue adequacy.
>
> * * *
>
> The fact that section [10704(a)(2)] contemplates something in addition to rate of return analysis is confirmed by its legislative history.

Id. 355 I.C.C. at 904. This finding was expressly reaffirmed by the Commission in its *Ex Parte Nos. 338* and *353* decisions. *See, Ex Parte No. 338*, 358 I.C.C. at 858-59, 904; 359 I.C.C. at 273; *Ex Parte No. 353*, 362 I.C.C. at 216.

In electing to rely solely upon the return on investment standard in *Ex Parte No. 393*, the Commission's decision did not even *address* the statutory question of whether Section 10704(a)(2) permitted the use of a single standard. Its argument in favor of the return on investment test was based solely upon considerations of "policy." At no point in the *Ex Parte No. 393* decision did the Commission take note of its previous findings that the statute precluded the use of a single standard. At no point did the Commission explain how or why its previous holding that a multiplicity of standards were required by the law had been in error.

Decisions of this Court have made it crystal-clear that when an agency wishes to change its interpretation of a statute, it must explain why its earlier interpretation was incorrect. *Atchison, Topeka & Santa Fe Ry.* v. *Wichita Board of Trade*, 412 U.S. 800, 808 (1978) (*Wichita Board*) (plurality opinion); *Secretary of Agriculture* v. *United States*, 347 U.S. 645, 652-54 (1954). *Accord*, *Central Power & Light Co.* v. *United States*, 634 F.2d 137, 150 (5th Cir. 1980), *cert. den.* 454 U.S. 831 (1981). As explained by the plurality in *Wichita Board*, this principle is a "simple but fundamental rule of administrative law. . ." *Id.* at 807 (quoting *SEC* v. *Chenery Corp.*, 332 U.S. 194, 196 (1947)). Under this principle, the Commission's abrupt and unexplained departure from its own statutory findings is clearly reversible error, and should have been so recognized by the Court of Appeals.

Section 10704(a)(2) forbids the reduction of revenue adequacy determinations to any single standard, such as the return on net investment test. This fact is borne out by the terms of the statute itself and its accompanying legislative history—and has been recognized by the U.S. Court of Appeals for the D.C. Circuit as well as by the Commission itself in its prior revenue adequacy proceedings. In *Ex Parte No. 393* the Commission made no explicit finding that the statute authorized its action and in no way identified or explained the error of its prior decisions. While Petitioners pointed this deficiency out to the court below, the court was unmoved and affirmed the Commission's action. These departures from established rules of administrative decisionmaking clearly demand consideration by this Court, and reversal of the Court of Appeals' decision.

B. Contrary To The Statute And Basic Precepts Of Ratemaking Enunciated By This Court, The Court Of Appeals Upheld The ICC's Decision To Include Unused And Nonuseful Assets In The Carriers' Rate Base

Section 10704(a)(2) declares that the ICC is to maintain standards for revenue adequacy that will cover a return on capital "employed in the business" of railroading. This statutory command reflects a basic rule of regulation, long recognized by this Court, that a regulated entity is not entitled to a return on assets "not used and useful" in rendering its services. *See, e.g.*, *Denver Union Stock Yard Co.* v. *United States*, 304 U.S. 470, 475 (1938). This principle was recently summarized by the D.C. Circuit, which, after reviewing the decisions of this Court, concluded that the exclusion of unused and nonuseful assets was an enduring regulatory precedent:

> In *Smyth* v. *Ames* [169 U.S. 466, 546] the Supreme Court articulated the guiding principle that 'the basis of all calculations as to the reasonableness of rates to be charged . . . must be the fair value of the property *being used by it for the convenience of the public.*' Although methods for determining values of rate base items have evolved since *Smyth* v. *Ames*, the precedent endures that an item may be included in a rate base only when it is 'used and useful' in providing service.

Tennessee Gas Pipeline Co. v. *FERC*, 606 F.2d 1094, 1109 (D.C. Cir. 1979) (emphasis in original) (footnotes omitted) *cert. den.* 445 U.S. 920 and 447 U.S. 922 (1980).

The "used and useful" property issue is of particular importance in the field of railroad rate regulation. Prior to its decision in *Ex Parte No. 393*, the Commission had for over half a century eschewed reliance on the rate of return standard as the sole determinant of the financial health of the rail industry because the railroad rate base is unregulated, and the used and useful character of that

base posed a question the ICC could not answer without conducting a valuation investigation. *See* Ex Parte No. 271, *Net Investment—Railroad Rate Base and Rate of Return*, 345 I.C.C. 1492, 1521 (1976).

In *Ex Parte No. 393*, the ICC recognized that elimination of assets "that are neither used nor useful" was "crucial" to its selection of the rate base/rate of return standard as the sole measure of carrier revenue adequacy. *Id.*, 364 I.C.C. at 811. Nevertheless, the ICC, with the Court of Appeals' approval (681 F.2d at 115), ignored its own logic and accepted a rate base that was not purged of unused or useless assets.[14] Review by this Court is necessary to resolve this glaring error in the ICC's rate base/rate of return standard.

C. The Court Of Appeals Authorized The Commission To Utilize A Cost Of Debt In Its Revenue Adequacy Standard Which Is Flatly In Conflict With The Statutory Scheme

Carriers, like other businesses, issue debt instruments. The cost of this debt to the carriers is the interest and principal payments they must make, with the interest set forth in the debt contract. Section 10704(a)(2) requires the ICC to calculate the amounts carriers need for the "repayment of a reasonable level of debt." Prior to the issuance of the *Ex Parte No. 393* order, the Commission properly held that to meet the debt "repayment" criteria set forth in Section 10704(a)(2), carriers had to earn sufficient sums to meet the interest and principal

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[14] The only railroad witness to address the issue concluded, in his limited analysis of only one part of the carriers' rate track structures accounts, that this part included nearly $225,000,000 in unused and nonuseful property. See Joint Appendix filed in the Court of Appeals at page 317.

repayment requirements actually set forth in their debt contracts, the so-called "embedded" level of debt. *Ex Parte No. 353*, 362 I.C.C. at 224; *Ex Parte No. 338*, 358 I.C.C. at 894.

In *Ex Parte No. 393*, the ICC reversed itself by holding that all of the carriers' debt costs would be considered equal to their *current* cost of debt, even though much of this debt was contracted for years ago at lower rates. *Id.*, 364 I.C.C. at 816. Thus, for example, if a carrier issued in 1970 a bond carrying a 6% interest charge, under its decision the ICC would assume for purposes of Section 10704(a)(2) that the carrier would have to earn a return equal to the interest rate on debt issued at the current time. If the current interest rate on debt was 12%, the Commission would consider the 6% bond to be a 12% bond. This methodology drastically misstates carrier debt costs. Indeed, using 1979 data, carriers' debt costs for revenue adequacy purposes (i.e., using current debt costs) would be $201,000,000 greater than their actual cost of debt.[15] The Court of Appeals' conclusion upholding this overstated capital cost should be set aside.

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[15] See Joint Appendix filed in the Court of Appeals at page 672. Where current debt rate is higher than the embedded debt rate, use of the current debt rate rather than the embedded debt rate also distorts the equity requirements established by the Commission and the Congress for revenue adequacy. To the extent that a railroad earns in excess of its embedded debt rate, the excess monies will flow directly through to the equity holder. Thus, the actual rate of return will not be the rate of equity return established by the Commission in its revenue adequacy proceedings, but will be that rate of return *as increased* by the difference between the embedded and current debt return.

III.

THE COURT OF APPEALS' RULING THAT DEFERRED TAX RESERVES MAY BE INCLUDED IN THE RAILROADS' RATE BASE CONFLICTS WITH THE DECISIONS OF THREE OTHER COURTS OF APPEALS ON THE SAME MATTER

In determining the sum of money that should be included in the railroads' net investment base under the rate of return standard which it adopted, the ICC included those amounts carried on their books as reserves for deferred federal income taxes. *Ex Parte No. 393*, 364 I.C.C. at 813-814. Such reserves for deferred taxes are created when accelerated depreciation is used by the railroads for tax purposes, while at the same time railroad ratepayers provide funds as if the straight-line depreciation accounting used for ICC purposes was also being used for federal tax purposes. Unless and until the deferred federal income taxes are paid, the funds provided by the ratepayers and included in the deferred tax reserves are available to the railroads for investment, free from any requirement that they pay interest or dividends. *Cf.*, *FPC* v. *Memphis Light, Gas and Water Division*, 411 U.S. 458, 459-460 (1973).

The ICC, however, with the approval of the Court of Appeals, declined to treat the deferred tax reserves as cost-free capital, either by deducting them from the rate base before applying the adopted rate of return to determine the railroads' revenue adequacy or by applying an adjustment to the required rate of return to reflect the cost-free nature of these capital funds provided by the railroad ratepayers.

This action by the Court of Appeals in approving the ICC's treatment of deferred tax reserves is in conflict with decisions on the same issue by three other courts of appeals. *See*, *Antonio, Texas* v. *United States*, 631 F.2d

831, 847 (D.C. Cir., 1980); *Iowa Public Service Company* v. *I.C.C.*, 643 F.2d 542, 546-547 (8th Cir., 1981); and *Cleveland-Cliffs Iron Co.* v. *I.C.C.*, 664 F.2d 568, 586 (6th Cir., 1980). The Court of Appeals' discussion of this issue not only fails to recognize the contrary decisions in other courts of appeals, but evidences a basic misunderstanding of the issue.

The shipper petitioners before the Court of Appeals argued that when it elects to normalize for federal income taxes, the Commission must make an appropriate adjustment in the rate base or the rate of return to reflect the availability of this cost-free capital. Three United States Courts of Appeals have agreed that there must be an appropriate adjustment to account for the cost-free nature of the funds. For example, in *San Antonio*, *supra*, 631 F.2d at 847, the District of Columbia Circuit held:

> "As this court has recognized on more than one occasion, the principle of excluding a deferred tax reserve from the rate base, as such reserve comes into existence, is an *essential component* of an agency's election to normalize taxes for ratemaking purposes.[87] Otherwise the rate payer who has paid higher rates reflecting normalization accounting would be paying the carriers for earnings on the tax differential even though it was the rate payer who contributed the differential in the first place.
>
> 87. E.g., *Public Sys.* v. *FERC*, 606 F.2d 973, 975-76 (D.C. Cir. 1979); *Memphis Light Gas & Water Div.* v. *FPC*, 500 F.2d 798, 800 (D.C. Cir. 1974). See Warren, Tax Accounting in Regulated Industries: Limitations On Rate Base Exclusions, 31 Rutgers L. Rev. 187, 189-94 (1978).

The question in the present case is not whether railroads should be permitted to *earn* a return on the funds generated by normalization, which are accounted for as reserves for deferred taxes. Petitioners did not make this

contention in the court below, and do not so argue here. Rather, the question is whether, in determining revenue adequacy, the railroads should be deemed to have incurred capital costs in obtaining these deferred tax funds which are provided by the ratepayers without cost to the railroads. The failure of the Court of Appeals to recognize this distinction further contributed to its erroneous treatment of the deferred tax issue.

Over $3.5 billion was included in the deferred tax accounts of the Nation's Class I railroads in 1979. Using a 1979 cost of capital, the inclusion of this cost-free capital would increase the carriers' annual revenue "requirement" by at least $634 million.[16] The Court of Appeals' decision to allow this addition of $634 million in nonexistent capital costs must be reviewed to resolve the conflict among the courts of appeals on this issue.

[16] See Joint Appendix filed in the Court of Appeals at page 667.

CONCLUSION

For the foregoing reasons, certiorari should be granted and this matter should be set for briefing and oral argument before this Court.

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February 14, 1983

APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 81-1492

BESSEMER AND
LAKE ERIE RAILROAD COMPANY,
Petitioner

v.

INTERSTATE COMMERCE COMMISSION and
UNITED STATES OF AMERICA,
Respondents

ASSOCIATION OF AMERICAN RAILROADS,
WESTERN COAL TRAFFIC LEAGUE,
Intervenors

CENTRAL ILLINOIS LIGHT COMPANY MIDDLE SOUTH UTILITIES SYSTEM ARKANSAS-MISSOURI POWER COMPANY ARKANSAS POWER & LIGHT COMPANY LOUISIANA POWER & LIGHT COMPANY MISSISSIPPI POWER & LIGHT COMPANY NEW ORLEANS PUBLIC SERVICE INC. POTOMAC ELECTRIC POWER COMPANY PUBLIC SERVICE COMPANY OF INDIANA, INC. SOUTH CAROLINA PUBLIC SERVICE AUTHORITY THE NATIONAL INDUSTRIAL TRAFFIC LEAGUE CAROLINA POWER & LIGHT COMPANY SOUTH CAROLINA ELECTRIC AND GAS COMPANY VIRGINIA ELECTRIC AND POWER COMPANY AMERICAN IRON AND STEEL INSTITUTE,
Intervenors

No. 81-2633

ALABAMA POWER COMPANY.
GEORGIA POWER COMPANY.
GULF POWER COMPANY.
MISSISSIPPI POWER COMPANY.
SOUTHERN COMPANY SERVICES, INC.,
Petitioners

v.

UNITED STATES OF AMERICA and INTERSTATE COMMERCE COMMISSION,
Respondents

WESTERN COAL TRAFFIC LEAGUE.
Intervenor

CENTRAL ILLINOIS LIGHT COMPANY MIDDLE SOUTH UTILITIES SYSTEM ARKANSAS-MISSOURI POWER COMPANY ARKANSAS POWER & LIGHT COMPANY LOUISIANA POWER & LIGHT COMPANY MISSISSIPPI POWER & LIGHT COMPANY NEW ORLEANS PUBLIC SERVICE INC. POTOMAC ELECTRIC POWER COMPANY PUBLIC SERVICE COMPANY OF INDIANA, INC. SOUTH CAROLINA PUBLIC SERVICE AUTHORITY THE NATIONAL INDUSTRIAL TRAFFIC LEAGUE CAROLINA POWER & LIGHT COMPANY SOUTH CAROLINA ELECTRIC AND GAS COMPANY VIRGINIA ELECTRIC AND POWER COMPANY AMERICAN IRON AND STEEL INSTITUTE ASSOCIATION OF AMERICAN RAILROADS.
Intervenors

No. 81-2634

CHEMICAL MANUFACTURERS ASSOCIATION,
Petitioner

v.

UNITED STATES OF AMERICA and INTERSTATE COMMERCE COMMISSION,
Respondents

WESTERN COAL TRAFFIC LEAGUE,
Intervenor

CENTRAL ILLINOIS LIGHT COMPANY MIDDLE SOUTH UTILITIES SYSTEM ARKANSAS-MISSOURI POWER COMPANY ARKANSAS POWER & LIGHT COMPANY LOUISIANA POWER & LIGHT COMPANY MISSISSIPPI POWER & LIGHT COMPANY NEW ORLEANS PUBLIC SERVICE INC. POTOMAC ELECTRIC POWER COMPANY PUBLIC SERVICE COMPANY OF INDIANA, INC. SOUTH CAROLINA PUBLIC SERVICE AUTHORITY THE NATIONAL INDUSTRIAL TRAFFIC LEAGUE CAROLINA POTOMAC ELECTRIC POWER COMPANY PUBLIC SERVICE COMPANY OF INDIANA, INC. SOUTH CAROLINA PUBLIC SERVICE AUTHORITY AMERICAN IRON AND STEEL INSTITUTE ASSOCIATION OF AMERICAN RAILROADS,
Intervenors

No. 81-2635

EDISON ELECTRIC INSTITUTE,
Petitioner

v.

INTERSTATE COMMERCE COMMISSION and UNITED STATES OF AMERICA,
Respondents

WESTERN COAL TRAFFIC LEAGUE,
Intervenor

CENTRAL ILLINOIS LIGHT COMPANY MIDDLE SOUTH UTILITIES SYSTEM ARKANSAS-MISSOURI POWER COMPANY ARKANSAS POWER & LIGHT COMPANY LOUISIANA POWER & LIGHT COMPANY MISSISSIPPI POWER & LIGHT COMPANY NEW ORLEANS PUBLIC SERVICE INC. POTOMAC ELECTRIC POWER COMPANY PUBLIC SERVICE COMPANY OF INDIANA, INC. SOUTH CAROLINA PUBLIC SERVICE AUTHORITY THE NATIONAL INDUSTRIAL TRAFFIC LEAGUE CAROLINA POWER & LIGHT COMPANY SOUTH CAROLINA ELECTRIC AND GAS COMPANY VIRGINIA ELECTRIC AND POWER COMPANY AMERICAN IRON AND STEEL INSTITUTE ASSOCIATION OF AMERICAN RAILROADS,
Intervenors

No. 81-2636

AMERICAN PAPER INSTITUTE, INC.,
Petitioner

v.

UNITED STATES OF AMERICA and
INTERSTATE COMMERCE COMMISSION,
Respondents

WESTERN COAL TRAFFIC LEAGUE,
Intervenor

CENTRAL ILLINOIS LIGHT COMPANY MIDDLE SOUTH UTILITIES SYSTEM ARKANSAS-MISSOURI POWER COMPANY ARKANSAS POWER & LIGHT COMPANY LOUISIANA POWER & LIGHT COMPANY MISSISSIPPI POWER & LIGHT COMPANY NEW ORLEANS PUBLIC SERVICE INC. POTOMAC ELECTRIC POWER COMPANY PUBLIC SERVICE COMPANY OF INDIANA, INC. SOUTH CAROLINA PUBLIC SERVICE AUTHORITY THE NATIONAL INDUSTRIAL TRAFFIC LEAGUE CAROLINA POWER & LIGHT COMPANY SOUTH CAROLINA ELECTRIC AND GAS COMPANY VIRGINIA ELECTRIC AND POWER COMPANY AMERICAN IRON AND STEEL INSTITUTE ASSOCIATION OF AMERICAN RAILROADS,
Intervenors

No. 81-2637

ASSOCIATION OF AMERICAN RAILROADS,
Petitioner

v.

INTERSTATE COMMERCE COMMISSION and THE UNITED STATES,
Respondents

WESTERN COAL TRAFFIC LEAGUE,
Intervenor

CENTRAL ILLINOIS LIGHT COMPANY MIDDLE SOUTH UTILITIES SYSTEM ARKANSAS-MISSOURI POWER COMPANY ARKANSAS POWER & LIGHT COMPANY LOUISIANA POWER & LIGHT COMPANY MISSISSIPPI POWER & LIGHT COMPANY NEW ORLEANS PUBLIC SERVICE INC. POTOMAC ELECTRIC POWER COMPANY PUBLIC SERVICE COMPANY OF INDIANA, INC. SOUTH CAROLINA PUBLIC SERVICE AUTHORITY THE NATIONAL INDUSTRIAL TRAFFIC LEAGUE CAROLINA POWER & LIGHT COMPANY SOUTH CAROLINA ELECTRIC AND GAS COMPANY VIRGINIA ELECTRIC AND POWER COMPANY AMERICAN IRON AND STEEL INSTITUTE
Intervenors

81-2638

IOWA ELECTRIC LIGHT AND POWER COMPANY, IOWA POWER AND LIGHT COMPANY, OKLAHOMA GAS & ELECTRIC COMPANY, SOUTHWESTERN ELECTRIC POWER COMPANY,

Petitioners,

v.

INTERSTATE COMMERCE COMMISSION and UNITED STATES OF AMERICA,

Respondents

WESTERN COAL TRAFFIC LEAGUE,

Intervenor

CENTRAL ILLINOIS LIGHT COMPANY MIDDLE SOUTH UTILITIES SYSTEM ARKANSAS-MISSOURI POWER COMPANY ARKANSAS POWER & LIGHT COMPANY LOUISIANA POWER & LIGHT COMPANY MISSISSIPPI POWER & LIGHT COMPANY NEW ORLEANS PUBLIC SERVICE INC. POTOMAC ELECTRIC POWER COMPANY PUBLIC SERVICE COMPANY OF INDIANA, INC. SOUTH CAROLINA PUBLIC SERVICE AUTHORITY THE NATIONAL INDUSTRIAL TRAFFIC LEAGUE CAROLINA POWER & LIGHT COMPANY SOUTH CAROLINA ELECTRIC AND GAS COMPANY VIRGINIA ELECTRIC AND POWER COMPANY AMERICAN IRON AND STEEL INSTITUTE ASSOCIATION OF AMERICAN RAILROADS,

Intervenors

No. 81-2859

WESTERN COAL TRAFFIC LEAGUE,
Petitioner

v.

UNITED STATES OF AMERICA and
INTERSTATE COMMERCE COMMISSION,
Respondents

CAROLINA POWER & LIGHT COMPANY AMERICAN PAPER INSTITUTE, INC. VIRGINIA ELECTRIC AND POWER COMPANY NATIONAL INDUSTRIAL TRAFFIC LEAGUE SOUTH CAROLINA ELECTRIC & GAS COMPANY ASSOCIATION OF AMERICAN RAILROADS AMERICAN IRON AND STEEL INSTITUTE CENTRAL ILLINOIS LIGHT COMPANY MIDDLE SOUTH UTILITIES SYSTEM ARKANSAS-MISSOURI POWER COMPANY ARKANSAS POWER & LIGHT COMPANY LOUISIANA POWER & LIGHT COMPANY MISSISSIPPI POWER & LIGHT COMPANY NEW ORLEANS PUBLIC SERVICE, INC. POTOMAC ELECTRIC POWER COMPANY PUBLIC SERVICE COMPANY OF INDIANA, INC. SOUTH CAROLINA PUBLIC SERVICE AUTHORITY NEVADA POWER COMPANY,
Intervenors

(ICC Ex Parte No. 393)

ON PETITION FOR REVIEW OF AN ORDER OF THE INTERSTATE COMMERCE COMMISSION

Argued: September 20. 1982

Before: GIBBONS, *Circuit Judge*, FISHER, *Chief Judge**
and MEANOR, *District Judge**

(Opinion Filed: October 19. 1982)

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OPINION OF THE COURT

GIBBONS, *Circuit Judge*

Various shipper interests petition pursuant to 28 U.S.C. §§2321, 2342(5) to review an order of the Interstate Commerce Commission (ICC) adopting a standard of revenue adequacy for market dominant carriers.[1] Ex Parte No. 393, *Standards for Railroad Revenue Adequacy*, 364 I.C.C. 803 (1981). Several carrier interests petition to review the same order.[2] The shipper interests contend that in several respects the order is more generous to the carriers than the law permits. The carrier interests, while generally defending the order, contend that the ICC erred in its treatment of rail properties currently unused or unuseful. We hold that the carrier petition presents issues not ripe for judicial review. As to the petitions of the shipper interests, we affirm the ICC order.

I.

The Regulatory Scheme

In 1976, confronting the total collapse of the railroad industry in the Northeast, Congress enacted the Railroad Revitalization and Regulatory Reform Act. Pub. L. No. 94-210, 90 Stat. 31 (hereinafter 4R Act). Two salient features of that legislation are relevant to the disposition of the instant petitions.

The first is the provision that "[n]otwithstanding any other provision of this part, no rate shall be found to be just and reasonable, on the ground that such rate exceeds a just or reasonable maximum for the service

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1. The shipper petitioners include businesses dependent upon, or trade organizations whose members are dependent upon, rail shipment of bulk commodities such as coal, iron ore, chemicals, and pulpwood.

2. The carrier petitioners include Bessemer and Lake Erie Railroad Company and the Association of American Railroads.

rendered or to be rendered, unless the Commission has first found that the proponent carrier has market dominance over such service." Pub. L. 94-210, §202(b), equivalent codified at 49 U.S.C. §10701a(b)(1) (1982). The effect of this provision was to end for most rail service decades of ICC control over maximum rates and to permit carriers not having market dominance to set rates in response to their perception of market conditions. Market dominance was defined as "an absence of effective competition from other carriers or modes of transportation, for the traffic or movement to which the rate applies." Pub. L. 94-210, §202(c)(i). *See* 49 U.S.C. §10709(a)(1982). The ICC has determined that there is effective competition for the traffic or movement to which a rate applies from (1) carriers or modes of transportation, serving the same origin and destination; (2) carriers or modes of transportation delivering the same product from the same origin to alternative destinations; (3) carriers or modes of transportation delivering the same product to the same distination from alternative origins; and (4) carriers or modes of transportation delivering substitute products to the same destination, irrespective of origin. 49 C.F.R. Part 1109; Ex Parte No. 320 (Sub-No. 2), ***Market Dominance Determinations and Considerations of Product Competition***, 365 I.C.C. 118, 129 (1981). Thus the category of market dominant carriers is a narrow one, involving services to shippers who by virtue of location and inability to use substitute products are captive customers of a rail carrier.

The second salient feature of the 4R Act is the enactment of a section dealing with the standard for ratemaking for those market dominant carriers still subject to ICC ratemaking jurisdiction. Section 205 of that Act directed the ICC "within 24 months after the date of enactment of this paragraph, after notice and an opportunity for a hearing, [to] develop and promulgate (and thereafter revise and maintain) reasonable standards and procedures for the establishment of revenue levels

adequate under honest, economical, and efficient management to cover total operating expenses, including depreciation and obsolescence, plus a fair, reasonable, and economic profit or return (or both) on capital employed in the business." Congress directed, further, that "[s]uch revenue levels should (a) provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation and (b) insure retention and attraction of capital in amounts adequate to provide a sound transportation system in the United States."

Acting under the mandate of Section 205 the Commission conducted two revenue adequacy proceedings, to which more particular reference will be made hereafter.[3] Meanwhile two major midwestern railroads went bankrupt, necessitating emergency federal legislation.[4] Congress, apparently dissatisfied with the pace of the ICC's revenue adequacy proceedings, passed the Staggers Rail Act of 1980, Pub. L. 96-448, 94 Stat. 1895 (hereinafter the Staggers Act). That Act amended the 4R Act in several respects. In an effort to increase railroad revenues, it created zones of rail carrier rate flexibility in which even market dominant carriers, if found to be revenue inadequate, could increase rates without ICC approval.[5] The Staggers Act also amended

3. Ex Parte No. 338, Standards and Procedures for the Establishment of Adequate Railroad Revenue Levels, 358 I.C.C. 844 (1978); Ex Parte 353, Adequacy of Railroad Revenue (1978 Determination), 361 I.C.C. 79 (1978); 362 I.C.C. 199 (1979).

4. See Rock Island Transition and Employee Assistance Act, Pub. L. 96-254, 94 Stat. 399 (1980); Milwaukee Railroad Restructuring Act, Pub. L. 96-101, 93 Stat. 736 (1979).

5. Pub. L. 96-448 §203. Revenue inadequate carriers were authorized to increase rates on services otherwise subject to ICC rate control as follows:

> (c)(1) During the 12-month period beginning on the effective date of the Staggers Rail Act of 1980 and during each of the 3 succeeding 12-month periods, a rail carrier may, in addition to rate increases authorized under subsection (b) of this sec-

section 205 of the 4R Act to provide that "[t]he commission shall maintain *and revise as necessary* standards and procedures for establishing revenue levels." Pub. L. 96-448, §205(b)(1). Moreover the ICC was directed to conclude a section 205 proceeding within 180 days after

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tion, increase any rate over which the Commission has jurisdiction under section 10709 of this title by an annual amount of not more than 6 percent of the adjusted base rate, except that in no event shall the total increase under this subsection result in a rate which is more than 118 percent of the adjusted base rate.

(2)(A) If any portion of a rate increase under this subsection is not implemented in the year in which it is authorized, such portion may, except as provided in subparagraph (B) of this paragraph, be implemented only in the next succeeding year.

(B) If any portion of the total rate increase authorized under this subsection is not implemented by the end of the 4-year period beginning on the effective date of the Staggers Rail Act of 1980, such portion may be implemented in the next 2 succeeding years, except that in no event may a rail carrier increase a rate under this subsection or under subsection (d) of this section in either of such 2 succeeding years by an annual amount of more than 10 percent of the adjusted base rate.

(d)(1) Except as provided in paragraph (3) of this subsection, during the 12-month period beginning on October 1, 1984, and during each succeeding 12-month period, a rail carrier may, in addition to rate increases under subsection (b) of this section, increase any rate over which the Commission has jurisdiction under section 10709 of this title by an annual amount of not more than 4 percent of the adjusted base rate.

(2) No portion of any rate increase under this subsection which is not implemented in the year in which it is authorized may be implemented in any other year.

Additionally, section 203 created "zones of rail carrier rate flexibility. 49 U.S.C. §10707a.

(c)(1) Any rail carrier rate which increased over 70 percent between 1976 and 1979 inclusive for the transportation, in shipper owned equipment over a distance exceeding 1,550 miles between points within the United States, of coal pursuant to a tariff calling for an annual volume of more than 2,000,000 tons per year purchased by a municipally owned utility for the generation of electric power under a 20-year purchase agree-

the effective date of the Staggers Act. Pub. L. 96-448 §205(b)(3). The effect of an ICC determination that a carrier is revenue inadequate, therefore, is to permit rail carriers to raise rates on services as to which they have market dominance, without ICC approval, within the zones of flexibility specified in the statute.

II.

The ICC Decision

Ex Parte No. 393 which we review is the ICC's response to the Staggers Act direction that it conclude a section 205 proceeding within 180 days. On December 3, 1980 the ICC issued a notice proposing to repeal its governing revenue adequate regulations and to adopt a new standard measure. 45 Fed Reg. 80150 (1980). Departing from the approach it took in two prior revenue adequacy proceedings, it determined that a railroad would be considered revenue adequate when it received a rate of return on net investment equal to the current cost of capital. It determined to measure current cost of capital by examining current cost of debt, rather than embedded or historical cost of debt, together with cur-

NOTE—Continued

ment entered into by such utility in the year 1974 shall not be increased so long as coal is purchased under such original agreement, except that —

(A) during the period beginning October 1, 1980, and ending September 30, 1987, the Interstate Commerce Commission may permit increases in such rate which result in a revenue-variable cost percentage of not more than 162 percent; and

(B) after October 1, 1987, such rate shall be subject to section 10701a of title 49, United States Code, and related provisions of such title governing regulation of rail carrier rates, except that until such rate results in a revenue-variable cost percentage that is equal to or greater than the revenue-variable cost percentage applicable under section 10709(d) of such title, such rate may not be increased more than 4 percent, in addition to inflation, in any year.

rent cost of equity. In determining the rate base the ICC included reserves for deferred taxes, authorized use of betterment accounting for valuation of track assets, valued other assets at depreciated book value, and included in the investment base unused and unusable rail assets. In calculating the cost of capital and rate base the ICC used the most recent data available; the operating results and cost of capital for 1979.

The adoption of current cost of capital as the sole rate of return standard is a modification of the approach taken by the ICC in Ex Parte No. 338, the first of its section 205 proceedings. In that case the commission indicated that "[a]dequate revenue determination for railroads, . . . should not be based simply on a rate of return at the cost of capital rate." 358 I.C.C. at 872. It also proposed to consider certain financial ratios as indicative of a railroad's ability to raise capital. These included fixed charge coverage, proportion of debt in the capital structure, return on shareholders' equity, and ratio of market value of common stock to book value. 358 I.C.C. at 859. Moreover the ICC proposed to use flow of funds analysis, which projects needed capital outlays and other fund requirements, determines funds available from operations and capital sources, and ascertains the extent to which such funds will fall short of projected fund requirements. This group of standards were also utilized in Ex Parte 353. 361 I.C.C. 79 (1978), 362 I.C.C. 199 (1979). In Ex Parte 393 the ICC justifies its elimination of the consideration of ratios, and of flow of funds analyses, as inappropriate indicators of long term revenue adequacy. 364 I.C.C. at 817.

III.

Scope of Review

The ICC's revenue adequacy standard is a product of notice and comment rulemaking. 5 U.S.C. §553(c). The rulemaking proceeding was unquestionably within

the ICC statutory jurisdiction. We may set aside its action, therefore, only if it is arbitrary, capricious, an abuse of discretion, or otherwise not according to law, or if it was adopted without observance of procedure required by law. 5 U.S.C. §706(1)(A),(D). We may not weigh the evidence before the ICC, or inquire into the wisdom of the promulgated regulations, and we may inquire into the soundness of the ICC's reasoning only to the extent of ascertaining that its conclusions are rationally supported. *United States v. Allegheny-Ludlum Steel Corp.*, 406 U.S. 742, 749 (1972); *Baltimore and O.C.T.R.Co. v. United States*, 583 F.2d 678, 685 (3d Cir. 1978). Moreover, even when ICC rulemaking represents a departure from that agency's prior position, so long as the policies it is pursuing can be discerned from its opinion, and those policies are consistent with congressional directives, we must defer to the ICC's agency judgment. *Atchison T. & S.F. R. Co. v. Witchita Bd. of Trade*, 412 U.S. 800, 809 (1973). The choice by an agency among alternative means for satisfying a statutory mandate, is exclusively for that agency. Within the limits of this highly deferential scope of review, we turn to the petitioners several objections.

IV.

The Shipper Objections

The shipper objections may conveniently be divided into two categories; those bearing upon the ICC's adoption of a single rate of return standard for revenue adequacy, and those bearing upon determination of the rate base against which that return is calculated. We address them in that order.

A. The Standard of Revenue Adequacy

In Ex Parte 393 the ICC supported its conclusion that the standard for revenue adequacy should be a rate of return equal to the cost of capital by noting:

> Such a standard is widely agreed to be the minimum necessary to attract and maintain capital in the railroad, or any other, industry. The cost of capital is the rate of return required of a firm by current and prospective holders of its securities. If a firm is unable to earn the cost of capital, investors will be unwilling to supply capital to it. (footnote omitted).

364 I.C.C. at 809. The ICC reviewed the verified statement of William J. Baumol, which it credited, that any decision which foreclosed the opportunity to earn a compensatory rate of return on a railroad's capital would guarantee deterioration of plant and equipment, neglect of replacement and opportunities for modernization, and withdrawal of railroad services valued by customers. It then reasoned:

> Railroads can obtain funds for investment only by offering rates of return comparable to other investment opportunities. Otherwise, investors will elect to invest their funds elsewhere. If railroads earn less than adequate rates of return because of inappropriate regulatory action, rather than because they are not providing a desired service, then the standards of the Rail Act and the clear thrust of congressional policy will be thwarted.
>
> The minimum rate of return that will allow railroads to obtain investment funds is the cost of capital. The cost of capital is, by definition, the rate at which the market values investment funds. As we have said, investments earning less than the cost of capital will, in general, not maintain existing funding nor obtain new funding because investors will have sufficient opportunities to invest their funds elsewhere at a higher rate of return. It is extremely important to add, however, that this is true of funds generated internally as well. Railroad management has little incentive to reinvest funds generated by ratepayers in continued rail use if greater re-

> turns are available elsewhere. Railroads are private companies whose stockholders would not permit such reinvestment. Thus, even retained earnings will not be invested in the company if they cannot earn a rate of return equal to the cost of capital.

364 I.C.C. at 810.

The shipper interest mount several attacks upon the decision to opt for a single standard, some procedural and others substantive.

1. Adequacy of Notice

Some shippers contend that the ICC notice of proposed rulemaking published in the Federal Register, 45 Fed. Reg. 80150 (1980) did not comply with 5 U.S.C. §553(b)(3). That section requires notice "either of the terms or substance of the subjects and issues involved." We have held that the statute requires a notice in sufficient detail to alert properly all interested parties as to important particulars affecting them, and thus to permit those parties to comment before being subjected to regulations. *Marshall v. Western Union Telegraph Company*, 621 F.2d 1246, 1254 (3d Cir. 1980); *American Iron & Steel Const. v. EPA*, 568 F.2d 284, 293 (3d Cir. 1977); *Wagner Electric Corporation v. Volpe*, 466 F.2d 1013, 1019 (3d Cir. 1972). We conclude that the notice adequately complied with the standards for notice laid down in this court's caselaw. Plainly it alerted shipper interests that the ICC perceived difficulties with the use of ratios, and flow of funds analyses. Moreover it gave explicit notice that the ICC considered the current cost of capital to be the "minimum rate necessary to attract and maintain capital in the railroad, or any other industry." 45 Fed. Reg. at 80152. That no more explicit notice was required is confirmed by an examination of the detailed comments actually received.

2. Absence of Codification

Some shippers contend that the ICC violated 79 U.S.C. §10704(a)(2), which requires that it "maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers," by declining to codify its revenue adequacy standards. The ICC held, and we agree, that neither the 4R Act as amended by the Staggers Act, nor any provision of the Administrative Procedure Act requires a specific format for a revenue adequacy determination. The agency provided notice in the Federal Register and an opportunity for comment. It published its decision, and provided Federal Register notice of its issuance. The public has been adequately informed as to how the ICC will make determinations of revenue adequacy. Codification in the Code of Federal Regulations might be appropriate, but certainly is not essential to the legality of the decision in Ex Parte No. 393.

3. Legality of a Single Standard

The shipper interests maintain that in adopting a rate of return equal to the current cost of capital as the single standard for revenue adequacy the ICC misinterpreted section 205. They point out that the only change which the Staggers Act made in section 205 of the 4R Act was the addition of the language "revise as necessary." This language, they urge, while it did contemplate possible revisions of the revenue adequacy standards announced in Ex Parte No. 338 and No. 353, did not mandate the elimination of ratios or of flow of funds analyis. Those standards, they insist, were required by section 205 as it originally appeared in the 4R Act. Chief reliance is placed on the sentence:

> Such revenue levels should (a) provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure repayment of a reasonable level of debt, permit the raising of needed equity capital and cover the effects of inflation and (b)

> insure retention and attraction of capital in amounts adequate to provide a sound transportation system in the United States.

Reliance is also placed on the reference in the prior sentence to "honest, economical and efficient management." Pub. L. 94-210 §205(2). In support of their interpretation of the quoted language the shippers refer to language in Senate and House reports on the 4R Act. The Senate report explains:

> In considering adequate revenue levels, the Commission will be expected to utilize the most modern financial techniques available and to adopt a prospective view of carrier revenue needs. Previous analysis of the adequacy of regulated industry revenues has focused upon adequate returns on investment. While this type of analysis may need to be continued, it is equally important for the Commission to focus on the level of revenue needed to provide and maintain adequate service in the public interest. This requires emphasis upon present and future revenue levels under honest, economical and efficient management as opposed to a theoretically adequate rate of return on investment that may have no relationship to the need for operating and capital funds necessary to maintain service in the public interest.

S. Rep. No. 94-499: Report to the Senate Committee on S. 2718, Rail Services Act of 1975, November 26, 1975, pp. 51-52. House Report No. 94-725, 94th Cong. 1st Sess. 73 (1975) states:

> In carrying out one of the primary objectives of this legislation, the reported bill amends . . . the Interstate Commerce Act . . . to require that the Commission establish standards for the establishment and maintenance of adequate revenue levels for railroads . . . . Needless to say, in establishing

> such standards, the Commission shall take into consideration productivity factors and financially sound debt and equity ratios.

The shippers contend that in light of this legislative history section 205 must be read as requiring separate standards addressed to financial ratios, to flow of funds analysis, and to productivity. They make this contention, obviously, in hopes that utilization of these additional standards will produce a level of revenue adequacy lower than that resulting from application of the current cost of capital standard. This, they hope, will prevent more carriers from taking advantage of the zones of rate flexibility in 49 U.S.C. §10707a. The shippers do not dispute that the ICC standard will provide an opportunity to attain revenue levels at least equal to those which might be authorized if the other proposed standards were employed.

The ICC interprets section 205 differently. It concludes that the section was addressed to the *opportunity* to attain revenue levels which would reverse the long decline in the railroad industry. The specific objectives listed in section 205 should not in its view be read as limitations on revenue, and may all be attained under the current cost of capital standard. The ICC urges, as well, that the Staggers Act was intended to create a regulatory environment more favorable to investment in railroads. Congress' concern was "to reform Federal regulatory policy so as to preserve a safe, adequate, economical, efficient and financially stable rail system" and "to assist the rail system to remain viable in the private sector of the economy." Pub. L. 96-448, §§3(2) and (3), 94 Stat. 1897. Despite the use of financial ratios and of flow of funds analysis in Ex Parte Nos. 338 and 353, the economic difficulties of the railroad industry continued under the 4R Act. Thus, the ICC points out, adoption of the more all encompassing current cost of capital standard was suggested by experience. As to productivity and honesty in management, it reads the statutory

references to those matters as expressions of concern that carriers with honest, economical and efficient management have the opportunity to achieve adequate revenues. If the management is not honest, economical and efficient it will not, despite such opportunity, attract capital or retain business.

Given the highly deferential scope of review by which this court is confined, we cannot hold that the adoption of a single standard encompassing the objectives listed in section 205 must be set aside. The overall policy pursued by the agency is entirely consistent with Congressional directives. Reasons for departure from the ICC's prior position with respect to use of financial ratios and flow of funds analysis, and for refraining from incorporating productivity standards under section 205, have been carefully explained. While some other standard or combination of standards might also accomplish the overall objectives of the 4R and Staggers Acts, the choice among permissible alternatives is to be made by the agency to which rulemaking authority has been delegated, not by this court.

The shippers urge that the ICC's interpretation of section 205 puts them, as customers of market dominant carriers, entirely at the mercy of those carriers. That contention ignores the distinction in the statute between revenue adequacy proceedings and rate reasonableness proceedings. Carriers deter mined to be revenue inadequate may, without ICC approval, raise rates within the zones of reasonableness set out in 49 U.S.C. §10707a. Individual shippers who object to specific rates may file complaints against market dominant carriers challenging the reasonableness of such rates. 49 U.S.C. §§11701(b), 11705. In such proceedings the ICC retains authority to prevent imposition of unreasonable rates on market dominant traffic. Among the factors which it may consider in rate reasonableness proceeding are the inefficiency or dishonesty of the carriers' management, and discrimination in rates which may result in subsi-

dizing competitive traffic with charges imposed on captive shippers. As the ICC points out, a revenue adequacy determination is no guarantee that any carrier will attain any level of revenue.

Thus, we conclude that the ICC's adoption of the single standard of revenue adequacy — a rate of return equal to the current cost of capital — is consistent with section 205, and is not arbitrary, capricious, or an abuse of discretion.

4. Current vs. Embedded Debt

Perhaps the most strenuously voiced shipper objection to the ICC's standard is its reliance on current cost of debt capital instead of cost of embedded debt. The shippers do not object to looking to the current market for the proper return on equity investment. Nor do they object to the ICC's assumptions about a proper ratio between debt and equity investment in the railroad industry. They do object, however, that by looking to the current cost of debt, when many carriers owe debt which was contracted for years ago at lower interest rates, the ICC is affording to the stockholders the opportunity to make a return on investment represented by debt in excess of its cost.

The ICC's position is entirely consistent with section 205, and with the overall scheme of regulation of the 4R and Staggers Acts. In an unregulated industry it would be the object of management, by judicious resort to borrowed funds, to make capital investments which properly utilized would earn in excess of the cost of borrowed funds, thereby providing leverage for stockholder investors. Public utility regulation, by contrast, provides for an assured rate of return to regulated monopolies. In fixing an assured rate of return, it is not unfair to take into account only the embedded cost of debt. Railroad regulation by the ICC, is not, however, classic public utility regulation. For the most part railroads operate in a

competitive environment. It is true that under the 4R and Staggers Acts they are subject to regulation of rates for market dominant traffic. They are not, however, assured of a compensable rate of return even on the investment required to serve that traffic. The purpose of the revenue adequacy determination required by section 205 is to determine which railroads may resort to the flexibility in raising rates provided for elsewhere in the statute. Revenue from all traffic, competitive as well as market dominant, is taken into account for that purpose. There is no reason to suppose that Congress intended to restrict railroads having market dominance in specific instances to a level of revenue determined by its embedded cost of debt service. Such an interpretation of the statute would be inconsistent with the expressed intent of opening capital markets to the railroads, and of encouraging reinvestment of internally generated funds. If the railroads could not gain a rate of return on investment represented by old debt in excess of the old interest rates on such debt, they would be unlikely to attract new equity capital, and their shareholders would insist on investment of internally generated funds outside the rail industry.

Several shippers contend that by using current cost of debt in the revenue adequacy determination the ICC will tend to overcompensate carriers in time of high interest rates, while undercompensating them when their embedded interest rates exceed current rates. We have already rejected the contention that the carriers may not enjoy leverage resulting from judicious earlier borrowing. As to the effect of the ICC's standard should interest rates collapse, the shippers' expressed concern is unrealistic. If old debt carries interest rates exceeding the current market, prudent management will replace it with new borrowings.

Thus, we conclude that the ICC decision to use current cost both of debt and of equity capital in determining an adequate rate of return is consistent with section

205, and is not arbitrary, capricious, or an abuse of discretion.

B. The Investment Base

The shipper interests contend that several ICC rulings with respect to determination of the investment base to which its rate of return shall be applied are arbitrary, capricious, an abuse of discretion, or contrary to law.

1. Use of Betterment Accounting for Track Structures

In its notice of proposed rulemaking the ICC proposed using the sum of original cost plus betterments for the valuation of track structures, explaining that such numbers are readily available for railroads, while capitalized maintenance and depreciation numbers are not.[6] 45 Fed. Reg. at 80152. For all accounts using depreciation accounting it proposed using depreciated book value. *Id.* Several shippers urge that the ICC should have adopted depreciation accounting for track structures as well as for other assets, because betterment accounting may lead to overgenerous estimates of the value of an in-

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6. The ICC has explained betterment accounting as follows:

> Under [betterment accounting], the initial track installation cost is capitalized. This investment is not depreciated and remains in the property investment account until the track is abandoned under the theory that the track structure is maintained in a constant condition and depreciation expense would equal track maintenance costs. Instead of depreciation, track replacements are accounted for as track maintenance expenses, except if through the application of superior component parts (such as replacing 110-lb. rail with 132-lb. rail) a betterment occurs. In that instance, the excess cost of new parts over the current cost of new parts of the kind replaced is capitalized.

Alternative Methods of Accounting for Railroad Track Structures, 46 Fed. Reg. 32289 (1981).

vestment base, and to inaccurate reports of railroad profits. Although the ICC has recently indicated a willingness to reconsider the use of betterment accouting, in Ex Parte 393 it concludes:

> In continuing to think about this issue, we have grown more convinced that betterment accounting may underestimate — not overestimate — the value of the investment base. Track structure is valued at the original cost of the track at the time the original investment was made, plus betterments (valued at their original cost). Under depreciation accounting, track structure would continually be revalued. Due to inflation, track structure would, therefore, likely be valued at a higher level under depreciation accounting because its value is set at a later date.

364 I.C.C. at 812. The ICC acknowledged that the practice of considering all track maintenace except betterments to be an expense could overstate profits in periods of low maintenance and understate profits in periods of high maintenance. It concluded that it lacked information as to the direction or magnitude of these distorting effects, and that the betterment accounting data are the best currently available. *Id.* at 813.

Considering our limited scope of review, the industry practice of using betterment accounting for track structures, and the Congressional direction to the ICC in the Staggers Act to complete a revenue adequacy proceeding in 180 days, we cannot hold that the agency's decision to calculate the value of track structures by betterment rather than depreciation accounting should be set aside.

2. Failure to Exclude Unused or Useless Assets from the Rate Base

Some shippers urge that the ICC erred in failing to exclude from the railroads' ratebase assets which have not been formally abandoned, but which are neverthe-

less unused or useless. The statutory standard is "a reasonable and economic profit or return (or both) on capital employed in the business." 49 U.S.C. §10704(a)(2). In deference to that standard the ICC noted that it "must be careful not to overvalue the investment base by including in it assets that are neither used nor useful." 364 I.C.C. at 811. But because the Staggers Act required a revenue adequacy determination within 180 days the agency found it impossible to distinguish used and useful plant from that which was neither. It advanced two justifications for inclusion of all assets not formally abandoned at original cost plus betterments for track assets, and depreciated book value for all other assets. First, it found that the book value of unused and unuseful assets was significantly less than one percent of total net investment. Second, it found that railroads with the highest percentage of abandonable lines have had low profits, and thus are likely to be found revenue inadequate in any event. There is evidence in the record supporting both findings.[7]

We conclude that in determining for purposes of section 205 what capital is "employed in the business" of a railroad, the ICC has acted within the bounds of the discretionary authority conferred on it by Congress. The agency noticed for comment the question of possible unused and unuseful assets. 45 Fed. Reg. 80152-53. On the basis of information submitted in response to the notice it concluded that no adjustment to the book values of the investment base was necessary at this time, because no likelihood of substantial overvaluation was established. Thus we hold that the failure to calculate and exclude value of unused or unuseful assets, for purposes of the initial revenue adequacy determination mandated by the Staggers Act, was not arbitrary, capricious, or an abuse of discretion.

7. Statement of Charles W. Hoppe, "The Extent of Excess Capacity," V.S. #3, Comments of American Association of Railroads, at 7-8.

3. Reserves for Deferred Taxes

Under the Internal Revenue Code railroads, like other businesses, are permitted to take accelerated depreciation deductions. 26 U.S.C. §167(b). The effect of accelerated depreciation is to leave in the business, temporarily, funds which under normal depreciation funds accounting methods would be paid out as taxes on earnings. The tax benefit, assuming continuing profitable operations, is temporary, since in later years the unavailability of depreciation allowances on assets for which accelerated depreciation was elected results in higher income. In effect, by deferring the collection of taxes the federal government makes a temporary investment in the business.

The shipper interests contended before the ICC, and urge here, that reserves for deferred taxes should be excluded from the rate base. In making this argument, they urge adoption by the ICC of an accountng procedure utilized by some public utility regulatory bodies called normalization. Normalization means that a regulated utility, while it may calculate its tax liability using accelerated depreciation, must for rate making purposes report depreciation and earnings on a straight-line basis. *See* E. Warren, *Tax Accounting in Regulated Industries Limitations on Rate Base Exclusions*, 31 Rutgers L. Rev. 187, 190 (1978). Normalization accounting results in passing through to utility customers the tax savings resulting, temporarily, from accelerated depreciation.

In many respects the shippers' plea for normalization accounting for depreciation is similar to their plea for use of embedded rather than current cost of debt. By not deducting from the rate base a reserve for unpaid taxes, the ICC is permitting the railroads to earn for their stockholders a return on money the United States has temporarily invested in the enterprise. Since those funds are cost free, according to the shippers, no rate of return should be allowed on them.

The simple fact remains, however, that for all businesses accelerated depreciation is a source of funds which may be reinvested. If the railroad industry were to be put in the position that unlike unregulated industries it could not earn a rate of return on investment of such funds it would be at a competitive disadvantage in seeking equity capital, and it would be encouraged to invest the funds generated from accelerated depreciation elsewhere than in the railroad business. Perhaps in balancing the competing interests for shippers and rail carriers a commission decision excluding reserves for deferred taxes from the rate base would be a defensible interpretation of section 205. Indeed that was the ICC's earlier position.[8] In Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines Nationwide*, 364 I.C.C. 360 (1980), however, it reconsidered that position. Both in that case and in Ex Parte 393 it recognized that excluding deferred taxes from the ratebase would provide an incentive for railroads to invest in non-rail assets. It would, moreover, produce a rate of return below the cost of capital, since capital markets act with knowledge of the availability of accelerated depreciation as a source of funds.

The ICC's position on normalization of depreciation accounting is rationally supported. Its reasons for departure from its prior position are adequately explained, and its present policy is consistent with the Congressional directive in section 205. We may not disturb its decision in respecting reserves for deferred taxes.

V.

Carrier Objections

Some carriers object that the ICC opinion recognizing that some rail lines are so unused or unusable as to be potentially abandonable, intimated that in the future it might determine that unused or unusable lines ought

8. See San Antonio Texas v. United States, 631 F.2d 831, 847 (D.C. Cir. 1980).

to be excluded from the rate base for purposes of revenue adequacy determinations. They contend that so long as they are under a legal obligation to retain rail property, whether or not it is used or useful, its book value must as a matter of law be included as "capital employed in the business." 49 U.S.C. §10704(a)(2). The ICC points out, correctly, that no abandonable properties were excluded from the rate bases dealt with in Ex Parte 393. In its opinion the ICC observed:

> We have . . . decided, for purposes of this initial assessment, to use a method of asset valuation that does not explicitly address the question of identifying used and useful plant. We do this only because we believe such identification is not possible in the time allowed and because we believe that the valuation that will result from use of the method we are adopting is accurate.

364 I.C.C. at 811. Whether in the future any potentially abandonable properties will be excluded from the rate base is, at this point, entirely a matter of speculation. Thus we conclude that the shipper petition for review challenging the legality of any such exclusion presents an issue which is not ripe for judicial review. *Abbott Laboratories v. Gardner*, 387 U.S. 136 (1967); *West Penn Power Co. v. Train*, 522 F.2d 302 (3d Cir. 1975).

The carrier interests also urge that the ICC erred when in deciding Ex Parte 393 it relied upon cost of capital and operating results for 1979. Under the strict deadline for decision included in the Staggers Act, however, the ICC had no real choice but to rely on the most recent figures on operating results which were available; those for 1979. It could have relied upon information about capital costs in 1980, but its decision to utilize capital costs for the same year as the operating results upon which its revenue adequacy determinations were to be based was not an abuse of discretion.

VI.

Conclusion

The decision of the ICC in Ex Parte 393, 364 I.C.C. 803 (1981) will be affirmed in all respects.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit

APPENDIX B

INTERSTATE COMMERCE COMMISSION

EX PARTE NO 393

STANDARDS FOR RAILROAD REVENUE ADEQUACY

Decided March 26, 1981

Repeals existing standards and establishes as the standard of revenue adequacy a rate of return equal to the cost of capital.

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DECISION

BY THE COMMISSION

By notice served November 26, 1980, the Commission proposed that existing rules be repealed and new standards adopted for determining railroad revenue adequacy. These changes were proposed to enable the Commission to implement section 205 of the Staggers Rail Act of 1980 (Rail Act).

Background

Section 10704(a)(2) of the Interstate Commerce act requires the Commission to maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers adequate to cover total operating expenses, including depreciation and obsolescence, plus a reasonable return on capital. The act also states that adequate revenue levels should:

(a) provide a flow of new income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation; and

(b) attract and retain capital in amounts adequate to provide a sound transportation system in the United States.

Section 205(b)(2) of the Rail Act amends 49 U.S.C. 10704(a) by adding a new paragraph (3) directing the Commission to conclude a proceeding under 49 U.S.C. 10704(a)(2) within 180 days after its effective date. Section 205(b)(2) also adds a new paragraph (4) directing the Commission to determine which rail carriers are earning adequate revenues within the same 180-day period, and on an annual basis thereafter.

As discussed in the notice, the concept of revenue adequacy is important throughout the Rail Act. Section 101(a) of the Rail Act states that in regulating the railroad industry, it shall be the policy of the United States to promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues. Section 201(a) of the Rail Act states that in determining whether a rate established by a rail carrier is reasonable, the Commission shall recognize the policy that rail carriers shall earn adequate revenues. The zone of rate flexibility established by section 203 of the Rail Act may not be available after October 1, 1984, to carriers earning adequate revenues. Those carriers may not use the 4-percent zone above the adjusted base rate for single-line rates and, in all likelihood, joint-line rates. That section also provides that complaints challenging the reasonableness of rates increased under the zone are judged differently when they involve carriers with adequate revenues. Section 217(a)(1) of the Rail Act allows carriers not earning adequate revenues to have greater freedom in applying surcharges to joint rates.

In the notice, the Commission stated that adequate revenues should cover a railroad's costs plus an adequate rate of return on its investment base. The proposed standards separately considered the issues of adequate rate of return and valuation of the investment base. Comments were sought on these proposed standards. We also stated that we believed that individual railroads needed to be in sound financial condition in order for their revenues to be deemed adequate. The proposed standards contem-

plated using the operating ratio, the fixed charge coverage ratio and the throwoff-to-ratio as means of determining whether individual railroads are in sound financial condition. Public comment was requested as to whether standards regarding financial soundness are useful in assessing revenue adequacy, and whether the proposed measures are the most appropriate for this purpose.

We said that after considering comments filed in response to the notice, we would publish a final notice setting forth standards for determining railroad revenue adequacy and would employ those standards to determine which railroads are earning adequate revenues. These standards and the resulting individual railroad determinations are set forth here.

PRELIMINARY MATTERS

Several parties contend that we are not conducting this proceeding in accordance with Administrative Procedure Act (APA). The basis inconsistency alleged is that the notice of proposed rules was insufficient to give the public an opportunity for meaningful comment. Cited in particular were the lack of specific rules in the notice and an alleged lack of rationale for our departure from the Ex Parte Nos. 338 and 353 standards.

Section 553 of the APA sets our three procedural requirements for rulemaking proceedings: notice of the proposed rulemaking, an opportunity for interested persons to comment, and a statement of the basis and purpose of the rules ultimately adopted. *Home Box Office, Inc.* v. *F.C.C.*, 567 F. 2d 9, 35 (D.C. Cir. 1977), cert. denied, 434 U.S. 829 (1977). There is no stated requirement that notices be formulated in terms of specific rules. Rather, section 553 specifies instead that either the terms or substance of the proposed rule or a description of the subjects and issues involved shall be included in the notice.

Whether a notice adequately satisfies this requirement must be tested by determining whether the notice would fairly appraise interested persons of the subjects and issues before the agency. *American Iron & Steel Inst.* v. *Envir. Prot. Agency*, 568 F. 2d 284, 293 (3d Cir. 1977); *National Indus. Traffic League* v. *United States*, 396 F. Supp. 456, 460 (D.D.C. 1975). In other words, the notice must allow an exchange of views, information, and criticism between interested persons and the agency. *Home Box Office, Inc., supra.*

Our notice of proposed rulemaking satisfied these criteria. It is clear from the notice that the subjects and issues to be considered included the impact of the Rail Act on revenue adequacy standards, the use of rate of return as a standard, valuation of the investment base, and the use of

financial ratios in revenue adequacy determinations. Furthermore, the notice, by referring to our prior lengthy decision on revenue adequacy, provided background material and demonstrated that the concepts discussed were already familiar to the agency and the public. That the notice was sufficient to allow public comment and agency response is indicated not only by the volume of comments received, but by our discussion of these comments throughout this decision.

Various parties also contend that rules published in the Code of Federal Regulations (CFR) are required either under the APA or as a result of the requirement in section 10704(a)(2) that the Commission maintain standards and procedures for establishing adequate revenue levels. We disagree. Neither the APA nor section 10704(a)(2) specifies the format which our standards must take. See, *e.g.*, section 552 of the APA which requires only that publication be made in the Federal Register. The decision here concludes that the appropriate standard is a return on investment equal to the cost of capital, and describes the methodology used to calculate present returns on capital. That decision, along with a Federal Register notice of issuance of the decision, is sufficient to inform the public as to how we will make determinations of revenue adequacy.

We have also indicated in this decision an intent to consider major modifications in our revenue adequacy methodology in future revenue adequacy proceedings. Thus rules published in the CFR would be particularly inappropriate at this time.

The argument that the notice does not provide sufficient rational for the proposed changes is also not convincing. Most of the cases cited by the parties on this question involved the adequacy of the rational for final decisions rather than for proposed rules. The APA also emphasized the importance of a statement accompanying final rules on the basis and purpose of the rules.

In any case, the notice did indicate that prior revenue adequacy decisions had discussed a range of standards, that various standards could be used for various purposes, and that the purposes of the newly enacted Rail Act could best be achieved by the standard proposed in the notice. Furthermore, another section of the decision here discusses again and in detail our reasons for adopting the proposed standards. We have concluded that these two discussions adequately describe the rationale supporting our decision.

In arguing that we have not complied with APA requirements, parties have cited various cases not discussed above, including *National Motor Freight Traffic Ass'n* v. *United States*, 268 F. Supp. 90 (D.D.C. 1967), affirmed 393 U.S. 18 (1960), *Pacific Gas & Electric Co.* v. *Federal Power Com'n*, 564 F. 2d 633 (4th Cir. 1977), cert. denied 435 U.S. 995 (1978),

and *Pickus* v. *United States Board of Parole*, 507 F. 2d 1107 (D.C. Cir. 1974). As these cases considered the initial question of whether a particular agency action required notice and a comment period, they are not relevant to the issues raised here. Here the issue raised was the adequacy of the notice rather than its necessity.

SUMMARY OF CONCLUSION

The comments submitted in this proceeding have been fully reviewed. Many expressed valid concerns and were thoughtful and useful. Some of the concerns raised are discussed here, but all were carefully considered. After reading and considering the comments, we continue to believe that revenue adequacy standards must be based on a rate of return equal to the current cost of capital.

We discuss below our reasons for modifying the standards set forth in Ex Parte No. 338, *Establishment of Adequate Railroad Revenue Levels*, 358 I.C.C. 844 (1978), 359 I.C.C. 270 (1978) and Ex Parte No. 353, *Adequacy of Railroad Revenue*, 362 I.C.C. 199 (1979), 362 I.C.C. 794 (1979). Several parties expressed the view that the Rail Act does not require the Commission to change its revenue adequacy standards.[1] We agree that the Rail Act contains no such requirement, However, after considering the overall thrust of the Rail Act, and the role it accords revenue adequacy findings, we believe new standards are necessary and appropriate. Specifically, we believe that in order for a railroad to be considered revenue adequate it must be earning a rate of return equal to the current cost of capital. This view is not new. As we stated in the notice instituting this proceeding:

> In Ex Parte No. 338 and Ex Parte No. 353, the Commission established standards and procedures for determining adequate railroad revenue levels. A return on investment equal to the cost of capital was only one of four standards the Commission indicated it would use in considering revenue adequacy. Financial ratios as indicators of financial structure, and flow of funds analyses were among the other standards considered in Ex Parte No. 338 and Ex Parte No. 353. Along with the cost of capital, these standards established a range of revenue adequacy. The range's high value is a measure of the cost of capital. The range's low value results from the use of a funds-flow model. This low value for revenue adequacy, however, does not and was never intended to define a long-term level of adequate revenue.[2] Rather, the low level calculation using funds-flow analysis is applicable only when it is necessary to assure that regulation per se does not provide carriers the current rate of return on redundant plant. Further, this measure conceptually establishes a

[1] These arguments are well summarized in the comments of the Edison Electric Institute, the National Industrial Traffic League, and the Western Coal Traffic League.

[2] We discussed this point at length several times in Ex Parte No. 353. See, for example 362 I.C.C. 223. There, we said, "That is, as unprofitable old investments are retired and new investments are made that earn a cost-of-capital return, a successful carrier's overall rate of return should gradually come to approximate the fair return level." This footnote is footnote 1 in the notice.

minimum level of revenue adequacy. The 4R Act directed the Commission to help carriers achieve adequate revenues. The Ex Parte No. 353 flow of funds determinations represent minimum target levels to be achieved. Revenue adequacy determinations are used differently in the Rail Act. In particular, carriers are denied additional rate flexibility if they are deemed revenue adequate. Thus, the Commission's determination will, to some degree, hold carriers' revenues down to the adequate level. In this context, minimum standards are not appropriate.

We want to make sure these views are stated as clearly as possible because we believe they are very important. We have not made radical changes in the standards of Ex Parte No. 353. Rather, we have adapted those standards in light of the role the Rail Act accords the concept of revenue adequacy. Funds-flow analysis and other minimum standards of revenue adequacy as described in Ex Parte No. 353 were and are appropriate as indicators only of the short-term viability of railroads. They were and are inappropriate as indicators of long-term revenue adequacy and are especially inappropriate as measures to limit rail pricing flexibility which is one of the roles the Rail Act accords revenue adequacy findings. If we adopted the Ex Parte No. 353 minimum or short-term standard for use here, we would likely in the next few years find ourselves denying a railroad the pricing flexibility necessary to obtain long-term revenue adequacy simply because that railroad was making some progress toward achieving that goal. In short, we would be assigning the railroads the Sisphyean task of working toward revenue adequacy, and every time it came close robbing it of the very means it had used to get there. We do not believe this is desirable nor do we believe it was intended by Congress.[3] Thus, our adoption of a rate of return standard is not a radical departure from our previous standards. Ex Parte No. 353 clearly accepted rate of return as a proper standard for ascertaining if a railroad has actually earned adequate revenues. In adopting such a standard here, we are only adapting our earlier findings to the mandate and policy of the Rail Act.

We also want to continue to emphasize that a finding of revenue inadequacy does not give a railroad license to set rates at unreasonable levels. As we stated in the notice:

An observation is in order concerning the relationship of revenue adequacy to the zone of rate freedom under section 203 of the Staggers Act. A carrier that lacks adequate revenue may, after October 1, 1984, continue to implement rate increases each year equal to 4 percent of its adjusted base rate. Nonetheless, the Commission may consider the reasonableness of such increases upon the filing of a complaint by an interested party (assuming that the carrier is found to have market dominance). For this purpose, it should be

[3] Congress recognized that our standards might need to be changed. Section 205(b)(1) of the Rail Act authorizes the Commission to "revise as necessary" its revenue adequacy regulations. Also see the Conference Committee Report on section 205 of the Rail Bill.

understood that the computation of an adequate revenue level for the carrier does not represent a guarantee that the carrier will attain such a revenue level. It should not be expected, in other words, that a carrier with inadequate revenue under the proposed standards will have unlimited freedom to raise its rates on market dominant traffic. As we emphasized in Ex Parte No. 353, revenue need is not the only factor to be considered when the reasonableness of a rate is determined.

A RATE OF RETURN STANDARD

We have decided to consider the issues of adequate rate of return and valuation of the investment base separately. Methods that do not separate these concepts, such as funds-flow analysis, have been discussed in the comments. We have rejected such methods because they rely wholly and uncritically on assumptions about the economic viability of the reasonableness of the return currently earned by the railroads on their current investment base.[4] Instead of using a method of revenue adequacy determination that uses unproven assumptions regarding asset valuation, we will consider this issue directly. While our methods of addressing this issue may not be perfect, we believe they are superior to methods that ignore it.

The standard we will use to measure the adequacy of the rate of return is the current cost of capital. Such a standard is widely agreed to be the minimum necessary to attract and maintain capital in the railroad, or any other, industry.[5] The cost of capital is the rate of return required of a firm by current and prospective holders of its securities. If a firm is unable to earn the cost of capital, investors will be unwilling to supply capital to it. This concept is discussed in detail in the verified statement of William J. Baumol.[6] He argues that "it is essential that regulation provide the *opportunity* for railroads to cover all their costs, including the cost of capital [emphasis in original]." He further argues that "any ICC decision which

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[4] In his verified statement for the Western Coal Traffic League, George Borts recognizes that the flow of funds approach addresses neither how much of the investment base is redundant nor the time needed to rationalize it. He believes, however, that this is an advantage. He argues that a funds-flow approach tells us how much a railroad must earn to be viable. As we discussed in the notice, and as the Association of American Railroads (AAR) discusses in their comments the implicit assumption of the Borts method is either that the railroad is already earning an adequate return on the existing investment base or that it can liquidate quickly those portions of its investment base that are not earning an adequate return. A troublesome aspect to this method is that if in applying this approach to a particular railroad neither of these assumptions is accurate, (and in many cases we think it would not be), a railroad earning less than adequate revenues would, nonetheless, be deemed revenue adequate. While it is true that the use of additional standards, such as our proposed financial indicators analyses, may lessen these problems of funds-flow analysis, we believe a method that has such biases is inconsistent with the goals of the Rail Act.

[5] This is a standard principle of economics. See, for example: James M. Henderson and Richard E. Quandt, Microeconomic Theory, 1958, pp. 243-252, or Burton G. Malkiel, "The Debt-Equity Combination of the Firm and the Cost of Capital: An Introductory Analysis," General Learning Press, 1971.

[6] William J. Baumol, "The Economic Principles Governing Rate of Return Regulation," Verified Statement No. 1, comments of the AAR.

forecloses the opportunity to earn a compensatory rate of return on the railroads' capital must guarantee deterioration of plant and equipment, neglect of replacement and opportunities for modernization, and, more generally, withdrawal in one way or another of railroad services which the market would otherwise show to be valued by customers at amounts that exceed their costs." AAR V.S. No. 1, at 1-2.

We agree. Railroads can obtain funds for investment only by offering rates of return comparable to other investment opportunities. Otherwise, investors will elect to invest their funds elsewhere. If railroads earn less than adequate rates of return because of inappropriate regulatory action, rather than because they are not providing a desired service, then the standards of the Rail Act and the clear thrust of congressional policy will be thwarted.

The minimum rate of return that will allow railroads to obtain investment funds is the cost of capital. The cost of capital is, by definition, the rate at which the market values investment funds. As we have said, investments earning less than the cost of capital will, in general, not maintain existing funding nor obtain new funding because investors will have sufficient opportunities to invest their funds elsewhere at a higher rate of return. It is extremely important to add, however, that this is true of funds generated internally as well. Railroad management has little incentive to reinvest funds generated by ratepayers in continued rail uses if greater returns are available elsewhere. Railroads are private companies whose stockholders would not permit such reinvestment. Thus, even retained earnings will not be invested in the company if they cannot earn a rate of return equal to the cost of capital.

Once again, we want to make to clear that we will not and cannot guarantee any railroad a return equal to the cost of capital. A railroad, like any other firm, should earn such a return only if it provides a desired service in an efficient manner. We want to take great care, however, not to deny railroads the opportunity to earn the cost of capital. Again, we agree with Professor Baumol:

> Any firm that is allowed to earn a long-run competitive return will, as a matter of course, be able, to the extent there is demand for its services, to cover all of its costs. It will also (in the words of the statute) have a 'flow of net income sufficient to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, cover the effect of inflation' and to otherwise meet the requirements of the statute. Conversely, it is impossible for a firm that is not earning a long run return equal to the cost of capital to meet these criteria. Most importantly, investor capital, whether purchased through the sale of new equity, or retained from earnings, will not be available in amounts adequate 'to provide a sound transportation system in the United States' unless a firm is earning a return equal to the cost of capital on all capital employed in the business of providing rail services. AAR V.S. No. 1, at 12.

In sum, we conclude that the only revenue adequacy standard consistent with the requirements of the Rail Act is one that uses a rate of return equal to the cost of capital.

USE OF ORIGINAL COST FOR THE INITIAL DETERMINATION

If we are to use the cost of capital to measure rate of return, and rate of return to measure revenue adequacy, then accurately measuring the investment base on which the rate of return is predicated is crucial. In particular, we must be careful not to overvalue the investment base by including in it assets that are neither used nor useful. Unless we eliminate unused and unuseful assets from our calculation, railroads that are, in fact, earning adequate revenues (adequate, that is, to sustain used and useful assets), will be considered to be revenue inadequate. However, the Rail Act requires an initial revenue adequacy determination within 180 days of enactment, and distinguishing used and useful investment from that which is not, is difficult, controversial, and time consuming. We have, therefore, decided, for purposes of this initial assessment, to use a method of asset valuation that does not explicitly address the question of identifying used and useful plant. We do this only because we believe such identification is not possible in the time allowed and because we believe that the valuation that will result from use of the method we are adopting is accurate.

In making our revenue adequacy findings in this proceeding, we have assessed the value of the rate base as the sum of the original cost of track assets plus betterments to track, plus the depreciated book value of all other assets.[7] The advantage of using original cost plus betterments in valuing track structures is that such numbers are readily available for railroads, while capitalized maintenance and depreciation figure are not. For accounts using depreciation accounting (all those other than track-related accounts), we used depreciated book value since such information was readily available.

We considered in the notice whether the failure to identify plant that is not used and useful would make our original cost asset valuation seriously inaccurate, or lead to anomalous results. We said:

> This approach does not explicitly address the question of identifying used and useful plant. That is, the question as to whether and to what extent a railroad's rate base ought to include the capital cost of plant and equipment that will not be renewed is not considered explicitly. Logically, such plant and equipment should be valued at something less than original cost plus betterments. However, given that such investments are likely to be car-

[7] This distinction between track and other assets is necessitated by the fact that we require betterment accounting for track assets, and depreciation for all others. We have used the book value of betterments as currently defined under betterment accounting procedures.

ried on the firm's books at a low original cost and are unlikely to have been bettered, we believe that the use of this approach will result in only a minor distortion. Notice at 10.

Data presented in this proceeding support this belief. In his verified statement, Charles W. Hoppe estimates the book value of lines in categories 1 and 3[8] of railroads' system diagram maps (those that have been identified as likely candidates for abandonment or have actually been proposed for abandonment) as significantly less than 1 percent of total net investment.[9] Further, Mr. Hoppe notes that the railroads with the highest percentage of abandonable lines have low profits and are not likely to be found to have adequate revenues even if the value of such lines were immediately written down to zero. We thus conclude that including plant that is not used and useful in the investment base is not likely to cause a significant overestimate of the original cost value of the investment base.

In the notice, we expressed concern that the use of betterment accounting might also lead to biased estimates of the value of the investment base. In proposing to use the sum of original cost plus betterments to arrive at a valuation of track structures, we noted that:

This corresponds to standard regulatory rate base formulations that include original cost plus capitalized improvements (less depreciation). Depreciation represents a source of funds to repay the cost of an asset over the asset's economic life. As plant and equipment age and are depreciated, the railroad's investment base decreases. However, when these long-term assets require improvements the railroad is also increasing its investment base through its expenditures on maintenance. Thus, depreciation approximates the asset's decreasing economic value, while the maintenance expenditures represent the renewing of the asset. Conceptually then, if plant and equipment are well maintained, capitalized maintenance and depreciation can theoretically offset one another. Notice at 9-10.

In continuing to think about this issue, we have grown more convinced that betterment accounting may underestimate—not overestimate—the value of the investment base. Track structure is valued at the original cost of the track at the time the original investment was made, plus betterments (valued at their original cost). Under depreciation accounting, track structure would be continually revalued. Due to inflation, track structure would, therefore, likely be valued at a higher level under depreciation accounting because its value is set at a later date.

Betterment accounting may also present an inaccurate picture of railroad profits. Since all maintenance other than betterments is considered to be an expense, a railroad's profits are understated in periods of high maintenance. Conversely, in periods of low maintenance, profits

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[8] In the notice, we inadvertently referred to classes 1 and 2 as those describing abandonable lines. Categories 1 and 3 are actually the correct references for this purpose.

[9] Charles W. Hoppe, "The Extent of Excess Capacity," V.S. No. 3, Comments of the AAR, at 7-8.

will be overstated, since the railroads will not be showing an expense to reflect consumption of their assets. This contrasts with depreciation accounting which would require a depreciation expense every year. We do not know with exactness either the direction or the magnitude of these distoring effects of betterment accounting. We do believe, however, that the betterment accounting data are the best available at this time.

In valuing the asset base, we also must consider how to treat funds obtained through tax provisions such as accelerated depreciation and investment tax credits. In the past, we have deducted deferred taxes (which generally result from use of accelerated depreciation) from the net investment base. This policy was explained in Ex Parte No. 338, where we wrote:

> We are cognizant of the fact that this treatment confers a benefit on the carriers, in that they are receiving and retaining revenue which is not accounted as income. As indicated by some of the parties, the capital funds arising from deferred taxes have been contributed by the ratepayers rather than by investors in the company. Thus, it is appropriate to deduct the deferred tax account from the net investment rate base prior to any calculation of rate or return.

This issue has come before us many time subsequently. For example, we considered it—and reached a different conclusion—in Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines—Nationwide,* 364 I.C.C. 360. We believe, after weighing all the concerns expressed by parties on both sides of this issue, that deferred taxes should not be removed from the net investment base for ratemaking purposes.

In our notice of proposed guidelines in Ex Parte No. 347 (Sub-No. 1), we said:

> The deferred tax account can be considered a source of funds freed up for reinvestment. These funds constitute a substantial part—up to 20 percent in some cases—of the total capital available to individual railroads for this purpose. To the extent that the railroads are not allowed to earn a return on investments made with these funds, the incentive to undertake railroad investments with such funds is substantially reduced. Instead, an environment is created in which there is an incentive to take funds generated within the railroad industry and invest them elsewhere, where market-determined rates of return are available. We are concerned that this may thwart the intent of Congress in passing the Revenue Acts of 1954 and 1962, to provide business enterprise with tax benefits as a means of spurring capital spending.

While we are not considering ratemaking per se here, the economic principle is the same. If we exclude internally generated funds, whether stemming from accelerated depreciation or any other railroad activity, from the investment base, the effect will be to establish a rate of return below the cost of capital. This, in turn, will result in incentives to railroads to invest these funds in nonrail operations. In short, we are con-

cerned that exclusion of the deferred tax account from the investment base would conflict with our duty under section 10704(a)(2)(A) of the Interstate Commerce Act as amended by the Rail Act to set revenue adequacy figures at levels that would "provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation."

We have carefully considered the argument presented in the verified statement of George H. Borts on behalf of the Western Coal Traffic League that special tax provisions should be excluded from the investment base since in a competitive industry competition will force the firm to pass the tax savings on to consumers in the form of lower prices. We reject this argument for two reasons. First, we again point out that we are not guaranteeing any railroad any rate of return. If competition generally has the effect postulated by Mr. Borts, then it will also have this effect on railroads. Second, we find the reasoning to be in error in two respects. The first is that tax (or other savings) will not be passed through to consumers if railroads are not covering economic costs, including the costs of capital. Railroads will either use these savings to help recover economic costs or will leave the market if they believe recovery is not likely. Our second concern with this reasoning is that while it is correct that if funds provided through tax benefits are restricted to use in a particular industry, then the additional investment may somewhat lower prices charged by that industry; however, as we explained above, the railroad industry must compete with all other industries for investment funds. The cost of capital reflects the minimum required rate of return expected by investors if they are to provide funds *after* all tax (and other) provisions are considered. That is, the cost of capital reflects the actual competitive return. We thus, reject this argument and conclude that the investment base should not be adjusted to reflect special tax provisions such as accelerated depreciation and investment tax credits.

COST OF CAPITAL DETERMINATION

For this initial revenue adequacy determination, which uses an original cost method of asset valuation, the proper cost of capital is the nominal cost. The nominal cost of capital is the cost of capital stated in the usual way in terms of current dollars. The nominal cost of capital is the sum of the real cost of capital and the expected rate of inflation. The conclusion is widely accepted that the nominal cost of capital must be applied to an original cost-based asset valuation if the railroads are to be compensated for inflation.

In previous revenue adequacy proceedings, we calculated the nominal cost of capital by taking a weighted average of the cost of equity capital

and the embedded cost of debt capital. The weighting was based on the capital structure of the railroads using embedded debt levels. We concluded in those proceedings that the rail industry's total capitalization could be fairly characterized as 40-percent debt and 60-percent equity. In the notice we asked for comments on whether these figures should be changed. We anticipated that we might receive comments indicating a perceived change in the industry's capital structure ratio. The railroads, however, made a strong argument that this ratio should be calculated using current debt rates and equity values. If this is done, they argue, the correct debt-equity ratio is not 40:60, but 23:77.

For purposes of this initial revenue adequacy determination, however, we will continue to use a 40:60 ratio. This is primarily because we are concerned that a change of the type suggested by the railroads was not anticipated in our notice, and not, therefore addressed by other parties. We believe before such a change is made further comment would be proper. We thus defer consideration of this method to a later proceeding.

In the notice, we also proposed to change the way we determine the current nominal cost of capital. Previously, we had based this rate on the cost of embedded debt and the market value of equity. We said in the notice, however, that we now believe that for a revenue adequacy determination the current cost of debt should be used. We reached this conclusion after considering what concepts a revenue adequate determination is designed to reflect. We noted that:

> Adequate revenues should assure retention and attraction of capital to provide a sound transportation system. A sound transportation system should return the cost of capital to investors and reflect that cost of capital in prices paid by users. These are forward-looking concepts. The year and the rate at which past debt was raised are not relevant for these purposes. The more relevant consideration is the cost to the railroad of raising (or not losing) capital for current and future investment. In periods of high and unpredictable rates of inflation, the use of embedded debt rates underestimates the cost of capital. Conversely, in periods when inflation fell below current levels, the embedded debt rate might over-estimate the cost of capital. If a railroad attempts to raise capital today, while maintaining its current capitalization structure, its cost of capital is the weighted average of the current cost of debt and the market value of equity. If the flexibility granted revenue inadequate carriers is restricted in periods of high debt rates to carriers earning less than the cost of capital calculated using the embedded debt rate, some economically efficient investments (those earning at least the current cost of capital) may be foregone. The use of the current cost of debt gives carriers the opportunity to make such efficient investments. We believe that this forward-looking approach is contemplated by the Rail Act.

Many comments argued that our proposed use of current debt rates instead of embedded debt rates is incorrect since holders of debt receive a return at the rate provided by the debt agreement regardless of what subsequent changes might occur in the cost of debt. While it is correct that

holders of debt are paid at embedded rate levels, we do not believe this is relevant. As we have noted repeatedly in this decision a revenue adequacy standard must provide railroads with the opportunity to compete for scarce investment funds. This means that railroads must be provided with the opportunity to earn a rate of return equal to the cost of capital. The current cost of capital is equal to the weighted average of the current rates of debt and equity.

Though only indirectly related to this proceeding, it is still interesting to contemplate what might happen in future rate cases if the embeeded debt rate argued for by many heavy users of rail service were adopted. In a rate case that came up in 1981, it is reasonable to assume that the rate would be premised on covering the cost of old debt—which was purchased at comparatively low prices. This would be to the advantage of rail shippers whose rates would reflect debt costs to the railroad well below the current market price. Let us assume further, however, that the railroads are today issuing debt instruments at much higher rates. Five years from today, rates will be premised on coverage of such debt instruments, even though debt might then be available at far lower rates. Shippers dependent on rail service would then be forced to pay rates at levels higher than would be necessary if current debt costs were used.

The same principle applies to a revenue adequacy determination. The use of embedded debt rates in calculating the cost of capital does not result in the minimum return necessary to attract capital to the railroad industry. In some years the calculated cost of capital would be too low; in others it would be too high.

For all of these reasons, we conclude that for purpose of revenue adequacy determination, we will use the current cost of debt in calculating the cost of capital.

Financial Ratios Indicative of a Carriers Financial Condition

In the notice, we observed that:

> While a financially sound firm must earn at a minimum a rate of return at least equal to the cost of capital, evidence that a carrier is earning an adequate rate of return is not sufficient to determine if it is earning adequate revenues. It is possible for a firm to earn the cost of capital over a short period, even though it is not financially sound. For example, a carrier may not have sufficient liquidity to meet financial obligations that are soon to come due. In recognition of this, we proposed to make a determination of sound financial condition an additional necessary condition for revenue adequacy. Notice at 16.

We further proposed to base this determination on specific financial ratios. Specifically, as additional necessary standards for a finding of revenue adequacy, we proposed an operating ratio of 0.85 or less, a fixed

charge coverage ratio of 3.5 or greater, and a throwoff to debt ratio of 3.5 or greater. We stated that the operating ratio (operating expenses as a percentage of operating revenue) would show whether a carrier's operations were covering its current expenses, while the fixed charge coverage ratio (income before fixed charges as a percentage of fixed charges) and the throwoff-to-debt ratio (cash flow as a percentage of long-term debt due within 1 year) would give indications of a firm's ability to meet its existing financial obligations. We asked for comments on whether the use of these ratios is appropriate, whether the figures proposed are the most suitable, and whether these three financial ratios are the best ones to show the soundness of a carrier's financial condition.

After considering these comments we now believe that using these financial ratios as conditions to a finding of revenue adequacy would be misleading. Financial ratios are intended to provide summary information that, if not interpreted within the proper context, could suggest incorrect conclusions. For example, a firm's fixed charge ratio might be low because of its ability to riase long-term debt. That ability could, in turn, be a reflection of its strong financial outlook. Yet the low fixed charge ratio would lead us to conclude the carrier was revenue inadequate. Because of the possible ambiguity, we have decided that these financial ratios should not be used in revenue adequacy determinations. We believe firmly that the rate of return standard is correct, and will base our determinations on it.

Interpretation of the Number of Carriers Found Revenue Adequate

Some participants in this proceeding have presented data showing that under the standards proposed in the notice only a small number of railroads will be found to have adequate revenues. The argument being made is that this finding indicates that the standard proposed in the notice is not valid. We believe the opposite is true. Sections 2(6) and 2(7) of the Rail Act explicitly found that the railroad industry's earnings are insufficient to generate funds for necessary capital improvements and that by 1985 there will be a capital shortfall within the industry of between $16 billion and $20 billion. These findings make clear that Congress did not anticipate that a large number of carriers would be found to have adequate revenues.

We recognize that the increase in revenue needed for findings of revenue adequacy may be large. We do not believe this indicates a problem with the standard. For example, in his verified statement, Donald V. Kane concluded that:

[I]n *1978 and 1979*, the estimated *increase in revenue requirements* for class I railroads as a whole, in order for those railroads to be determined revenue adequate under the I.C.C.'s "replacement cost" methodology is *not less than $8 billion per year*, i.e., an increase of approximately 33 percent.[10]

We note that this estimate may be inflated depending on how nonused and useful plant was eliminated from the base, and that, even with this possible problem, the estimate is not out of line with the estimate in the Rail Act.

Several parties have compared our individual railroad determinations in Ex Parte No. 353 with their estimate of individual railroad determinations using a rate of return standard. That the number of revenue adequate railroads differs under the two standards is not surprising. The two standards were designed to measure different concepts. We do not believe this indicates a problem with the rate of return-cost of capital standard.

THE USE OF REPLACEMENT COST ASSET VALUATION FOR FUTURE DETERMINATION

In the notice, we said that we were considering using a replacement cost methodology in valuing assets in future revenue adequacy determinations. Under the replacement cost valuation method we proposed, the investment base would be the sum of: (1) all investment that is used and useful (valued at its depreciated replacement cost); (2) all investment necessitated by regulation (value at its depreciated replacement cost); and (3) investment that is abandonable under current rules (valued at its net liquidation value). Since this calculation would already account for inflation, we noted that the current, real (as opposed to nominal) cost of capital would be the proper standard to use with a replacement cost valuation in order to make a revenue adequacy determination.

We continue to believe that replacement cost valuation can be preferable to original cost valuation. While the methods produce equal discounted cash flows, the regular and continuing calculation of depreciation charges and inflation adjustments under the replacement cost method may better reflect the true economic costs associated with an investment. Further, the replacement cost method is preferable becaue it comes closer to the competitive result. That is, at any point in time, the revenue requirement implications of using replacement costs are closer to the return on investment that would be required by a competitive

[10]Donald V. Kane, "Rates of Return and Revenue Requirements of Railroads under Ex Parte No. 393, January 23, 1981," appendix A, comments of the Edison Electric Institute, at p. 3. Emphasis in the original.

market. This occurs because the timing of inflation adjustments under the replacement cost method are more like those made by the market.

We recognized in our notice and acknowledge again here that the replacement cost method has data requirements that are more difficult than those of the original cost method. The major difficulty with using the replacement cost method is the estimation of the actual value of individual investments. Since this valuation is not based on actual transactions, the value of particular investments may be difficult to estimate. We are currently contemplating the initiation of a proceeding that will consider rules requiring railroads to file replacement cost data with the Commission. This method, if adopted, would be mechanized through the Commission's depreciation and life analysis systems. Using these systems, valuations based on depreciated replacement cost (original cost indexed to account for inflation), can be readily determined for all assets other than track. The track structure can be included by pricing it at current cost and depreciating such cost in a manner consistent with maintenance standards. Because the adoption of such a system would greatly lessen the problems of replacement cost valuation, we are deferring adopting a replacement cost method for future revenue adequacy determinations until that proceeding is begun, comments reviewed, and the issued raised decided.

An additional problem with the replacement cost method is that it requires use of the current, real cost of capital as the rate of return standard. The real cost of capital cannot be observed directly, but we believe that the real cost of capital can be calculated by subtracting some generally accepted estimate of inflation expected over the revenue adequacy determination period from our estimate of the nominal cost of capital. Such an estimate of the expected inflation rate might come from estimates already made by the Council of Economic Advisors or the Federal Reserve Board. Since we do not need to resolve this question in making our initial determination and have deferred the entire question of the replacement cost methodology, we are deferring further consideration of calculating the real cost of capital, as well.

We said in the notice that we expect that identification of which lines are used and useful and which are abandonable would be one of the most difficult elements of using the replacement cost method. We believe the best method of identifying such lines is to consider those in categories 1 and 3 of a railroad's system diagram map as abandonable under current rules. Category 1 lines are those the railroad will seek to abandon within 3 years. Category 3 lines are those for which the Commission is already considering an application for abandonment.

We recognize that, as argued by the railroads, a system diagram map identifies only those lines that have been or may be proposed for abandonment. While we understand that some lines proposed for abandonment may ultimately not be abandoned, we believe the system diagram maps provide the best available information on what is not used and useful. It is, after all, the railroad's evaluation of a line's prospects that placed it in either category 1 and 3. Further, as noted by Mr. Hoppe, those railroads that are most likely to be found revenue adequate generally have the least number of lines in categories 1 and 3. Thus, we would not expect this method of identifying abandonable lines to lead us to incorrect findings of revenue adequacy if and when the replacement cost method is adopted. We also do not expect that railroads will keep abandonable lines out of categories 1 and 3. Railroads have strong incentives to identify all abandonable lines since they are often costly to maintain, and under our present opportunity cost rules they may abandon lines that produce more revenue through liquidation than through continued operation.

While we perceive some difficulties in implementing a replacement cost valuation method, we believe that it is conceptually the best method available. We thus hope to adopt the replacement cost method for future revenue adequacy determinations, and will do so then based on this record. Decisions on the use of an accounting system that adjusts asset values and the calculation of a real cost of capital are deferred.

In the notice, we stated that we would consider conducting a proceeding using the replacement cost method if an affected party believed that the original cost method had not fairly indicated a railroad's revenue adequacy. In view of our deferral of a decision on replacement cost methodology, we will not entertain such petitions concerning the revenue adequacy determinations that we are making in this decision.

Revenue Adequacy Determinations

Based on the standards described above, we have made revenue adequacy determinations for 35 class I railroads. Data for 1979 are the most recent for individual railroads that are available for analysis. In Ex Parte No. 363, *Adequacy of Railroad Revenue (1979 Determination)*, 362 I.C.C. 344 (1979), we estimated that the cost of capital using the embedded debt rate was 11.0 percent. For this proceeding, we reestimated the cost of capital using the current cost of debt (and a 40:60 debt-equity ratio)

and have found it to be 11.7 percent.[11] Using the cost-of-capital standard for revenue adequacy, a railroad will be found adequate if it has a 1979 return on investment of 11.7 percent or higher.[12] Railroads with lower returns will be considered revenue inadequate.

After analyzing the data for the 35 class I railroads, we have found that only 3 earned adequate revenues in this most recent period. These railroads are the Bessemer & Lake Erie, Elgin, Joliet & Eastern, and Fort Worth & Denver.[13] Their rates of return were 11.7, 13.2 and 22.8 percent respectively. A summary of our finding for each railroad is contained in the appendix.

We find:

1. The current standards for revenue adequacy, found at 49 CFR 1109.25, are inappropriate for the purpose of the Rail Act and are repealed.

2. The standard for revenue adequacy shall be rate of return equal to the current cost of capital.

3. To assess the value of a railroad's rate base for the initial determination of revenue adequacy, we shall use the sum of the original cost of track assets, plus betterments to track, and the depreciated book value of all other assets. The investment base shall not be adjusted to reflect special tax provisions such as accelerated depreciation and investment tax credits. The cost of capital will be calculated using the current cost of debt and equity, and a debt-equity ratio of 40:60.

4. Under these standards, the following 3 of the 35 class I railroads are revenue adequate: Bessemer & Lake Erie; Elgin, Joliet & Eastern; and Fort Worth & Denver.

[11] In Ex Parte No. 363, *Adequacy of Railroad Revenue (1979 Determination)*, 362 I.C.C. 344 (1979), the Commission found the current cost of debt to be 9.0 percent and the cost of equity capital to be 13.5 percent. Using these values, the composite cost of capital in this proceeding was computed as follows:

$$\begin{array}{rr} 9.0 \times 0.40 = & 3.6 \\ 13.5 \times 0.60 = & 8.1 \\ \hline & 11.7 \end{array}$$

[12] Return on investment is computed by dividing net railway operating income (Annual Report Form R-1 Line 67, column (b)) by a calculated investment base. This base equals net investment in road and equipment (R-1, schedule 352 A, line 39, column d-column e) plus working capital from Rail Form A, minus interest during construction (R-1, schedule 352 B, line 43 columns b + c + d + e), minus other elements of investment (if debit), (R-1 schedule 352 B, line 47, columns b + c + d + e). The denominator is the average of beginning and end of year data.

[13] The FW&D is a wholly owned subsidiary of Burlington Northern Railroad. It may be, therefore, that it is misleading to consider it separately from its parent railroad, since we have very little information on financial transactions between the parent and the subsidiary. This entire question will be dealt with in a future proceeding.

5. This proceeding will not significantly affect either the quality of the environment or conservation of energy resources; nor will it have adverse economic effects on small businesses or other entities.

In this proceeding we have used 1979 data in order to meet the statutory deadline set by section 205(b) of the Rail Act. In the future, we will make every effort to guarantee that our annual revenue adequacy determinations are made as quickly as possible after data for the prior year become available. Since 1980 data will be available shortly, we will make our next revenue adequacy determination no later than September 15 of this year. Future annual revenue adequacy determinations will use the same time frame. This will minimize regulatory lag and improve the reliability of our calculations.

COMMISSIONER CLAPP, concurring in part and dissenting in part:

Occasionally, the Commission is called upon to make a decision which observers may view as a bellweather of regulatory philosphy. While some have tried to characterize this proceeding in this light, it would be a mistake to interpret it as such. Our task here is straight forward, although the solution is complex and elusive. We must ascertain theoretically and practically sound standards for measuring a railroad's relative financial condition. We cannot set standards based on a belief that we should find a certain number of carriers revenue adequate or inadequate—our standards must rest on their own inherent financial integrity.

It is also important to realize that the direct impact of the annual revenue adequacy determinations will not be great until October 1984. Currently, as a result of the Rail Act, a carrier deemed revenue adequate cannot impose a surcharge on its share of joint rates unless it applies to a line which carries at least 1 million gross ton-miles of traffic per mile per year. All carriers are assured that no rate can be found unnecessarily high if there is effective competition. Absent a contractual agreement, no railroad can be required to maintain a rate which returns less than a statutorily defined "cost recovery percentage" (160 percent of variable costs at present; depending on rail profitability this will escalate to between 170 and 180 percent of variable costs by October 1984). Additionally, cost increases are automatically passed through under a statutory formula. The railroads are also provided an additional "zone of rate flexibility" of 6 percent of the inflation adjusted rate per year. A rate within this zone may not be suspended, but if it is challenged the Commission must take carrier revenue adequacy or inadequacy into consideration. The statute emphasizes the importance of this factor, but does not detail specific consequences. In substance, this emphasis reflects Commission policy over the last several years.

Beginning with October 1984, a finding of revenue adequacy will have a more direct impact. The guaranteed "zone of rate flexibility" will change to 4 percent per year, but carriers deemed revenue adequate cannot use it. This does not mean that carriers which are revenue adequate automatically would be denied additional rate flexibility needed for them to maintain that status, but the possibility of challenge would be present.

To date, the Commission has received no indication that the few carriers who arguably could be considered revenue adequate under some alternative approach have any substantial interest in filing surcharges on joint-line movements. Assuming this continues, it is doubtful that the revenue adequacy determinations will result in any adverse regulatory consequences before 1984. The Commission will, of course, continue to take the financial condition of the railroads into account in exercising its responsibilities under the law. A financially sound railroad system is of essential importance to America's future transportation needs. The Rail Act has eliminated the uncertainty that some carriers felt in the past if they wanted to experiment with innovative pricing. We have encouraged such experimentation. This is a necessary and positive step toward railroad revitalization.

There is not a member of this Commission who doubts that it is important—indeed crucial—that the railroad industry be healthy and on a sound fiscal footing. We share—and are implementing—the resolve of the Congress that artifical restrictions which prevent the railroads from reaching that objective be removed. Concern regarding the efficacy of the particular test chosen for the determination of financial adequacy in no way reflects hesitation in the commitment to pursue that goal. That should be clearly understood. Nor, alas, does it signify that a perfect substitute is readily at hand. It isn't.

In this context, I am in substantial agreement with Commissioner Gilliam's observations. In theory, ROI is a sound indicator of many of the revenue adequacy criteria named by the statute. As used in this decision, however, there are certain technical deficiencies which limit its reliability in some situations. While the majority has acknowledged some of these deficiencies, others remain. For example, net railway operating income (NROI), the numerator of ROI, is calculated by subtracting all income tax expense from net revenue from railway operations. In some cases, the tax figure includes taxes attributable to nonrailroad related activities. If, as I believe we are required to, we are looking at railroad related activities, this will result in an inaccurate picture. Further, NROI, as presently computed, does not reflect certain rail-related income. The principal income sources are below-the-line items such as dividend

income and undistributed income from subsidiaries' rail activities (clearly, nonrail activities should not influence the results here), and interest income on railroad working capital investment.

One problem with trying to recompute ROI figures to take these matters into account is the fact that the income statement format presently used for reporting purposes does not permit segregation of income or expense accounts between rail and nonrail activities. This is an area which needs to be addressed in the future if a single ROI standard is to be used. Until problems such as this and others mentioned in the report can be resolved, we should check the results of our ROI computations against other relevant financial ratios such as a firms's operating ratio, throwoff to debt and fixed charge coverage ratios, return on shareholders' equity, return on total capitalization, the dividend payout ratio, and the annual percentage increase in net transportation investment.

A careful analysis of such ratios together with reported financial statements can be a useful tool in revealing any unusual characteristics which reliance on the single ROI figure will not show. Analysis of the facts behind the figures is essential since the methodology used in computing the figures has significant imperfections. This type of analysis will call for the exercise of some judgment, but I have great confidence in the ability of this Commission to make those assessments in a manner that will fulfill the intent of Congress. Until the practical problems with ROI can be remedied, this appears to be the most promising approach.

As a practical matter, in most instances, it would appear that the majority's determination and this suggested approach would lead to similar, although perhaps not identical, results. A substantial majority of the Nation's railroads clearly are revenue inadequate, in varying degrees. There are only two or three railroads which are clearly revenue adequate under any test. Under the ROI test, there are perhaps a handful more that could best be described as only marginally inadequate. Those firms may shift between adequacy and inadequacy in different years. Since revenue adequacy is a long-term concept, it makes more sense to use a 3- or 4-year moving average standard instead of looking only at 1979 figures as the majority does.

The majority's treatment of class I affiliated railroads appears inconsistent. Why, for example, are the Chessie System, Family Lines, and Burlington Northern affiliates looked at individually, while the Southern Railway System is treated only in the aggregate? Whatever treatment is used in future proceedings should be applied uniformly—either make determinations for all class I railroads without regard to affiliates, or make one determination for all affiliated lines.

It is my hope and expectation that lenders and other financial analysts reading this report will recognize that no one measure presently available can, as a practical matter, fully measure railroad revenue adequacy. Railroads which presently enjoy favorable credit ratings should not be penalized by financial institutions merely because this decision labels some of them revenue inadequate. Proper financial evaluation for that purpose requires a more sophisticated approach than is used here. By 1984, when our findings take on greater significance, I believe that most if not all of the problems noted can and should be resolved.

COMMISSIONER GILLIAM, concurring:

I agree with the majority that the return on investment (ROI) test is the most appropriate measure of railroad revenue adequacy. However, because of the present inaccuracies in the calculation of ROI, I would also use other financial ratios to make sure that our results are not distorted. While a single test is preferable in terms of simplicity, I am hesitant to rely solely on the use of one ratio until the application of ROI is further refined.

I concur in the result of this decision primarily because of the present limited application of our findings to the surcharge provision of the Rail Act. It is my hope that we will have eliminated the problems associated with the use of the ROI test prior to the time our findings have wider application.

It is ordered:

The regulations found at 49 CFR 1109.25 are repealed.

By the Commission, Acting Chairman Alexis, Commissioners Gresham, Clapp, Trantum, and Gilliam. Commissioner Gilliam concurred with a separate expression. Commissioner Clapp concurred in part and dissented in part with a separate expression.

AGATHA L. MERGENOVICH,
Secretary.

(SEAL)

Railroad revenue adequacy (1981 determination) (using ROI standard only) prepared by the Bureau of Accounts, Section of Financial Analysis

Carrier	1979	Determination of revenue adequacy
Eastern District	*Percent*	
Baltimore & Ohio	4.5	Inadequate
Bessemer & Lake Erie	11.7	Adequate
Boston & Maine	0	Inadequate
Chesapeake & Ohio	4.6	Do.
Conrail	0	Do.
Delaware & Hudson	0	Do.
Detroit, Tol. & Ironton	5.1	Do.
Elgin, Joliet & Eastern	13.3	Adequate
Grand Trunk Western	2.5	Inadequate
Norfolk & Western	8.9	Do.
Pitt & Lake Erie	10.1	Do.
Western Maryland	9.6	Do.
Southern District		
Clinchfield	11.6	Do.
Florida East Coast	1.5	Do.
Illinois Central Gulf	0	Do.
Louisville & Nashville	5.1	Do.
Seaboard Coast Line	7.2	Do.
Southern System	9.1	Do.
Western District		
ATCH, TOP, & Santa Fe	5.9	Do.
Burlington Northern	4.1	Do.
Chi & Northwestern	0	Do.
Chi, Milwaukee, SP & PAC	0	Do.
Colorado & Southern	0	Do.
Denver & Rio Grande W	8.6	Do.
Duluth, Mes & Iron RNG	6.1	Do.
Fort Worth & Denver	22.8	Adequate
Kansas City SO	6.6	Inadequate
Missouri-Kans-Tex	5.7	Do.
Missouri Pacific	8.4	Do.
St. Louis-San Francisco	5.8	Do.
St. Louis-Southwestern	7.5	Do.
Soo Line	8.2	Do.
Southern Pacific	1.6	Do.
Union Pacific	7.6	Do.
Western Pacific	4.4	Do.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 81-1492, 81-2633, 81-2634, 81-2635, 81-2636, 81-2637, 81-2638 and 81-2859

BESSEMER AND LAKE ERIE RAILROAD COMPANY,

Petitioner

Alabama Power Co., et al., Petitioners in No. 81-1493; Chemical Man. Assoc. Petitioner in No. 81-2634; Edison Electric Institution, Petitioner in No. 81-2635; American Paper Institute, Petitioner in No. 81-2636; Association of American Railroads, Petitioner in No. 81-2638; Iowa Electric Light & Power Co., et al., Petitioners in No. 81-2638; Western Coal Traffic League, Petitioner in No. 81-2859

v.

INTERSTATE COMMERCE COMMISSION AND UNITED STATES OF AMERICA,

Respondents

Association of American Railroads, et al., Intervenors in No. 81-1493; Western Coal Traffic League, et al., Intervenors in Nos. 81-2633/8; Carolina Power & Light Co., et al., Intervenors in No. 81-2859;
(ICC Ex Parte No. 393)

SUR PETITION FOR REHEARING

Present: GIBBONS, *Circuit Judge*, FISHER, *Chief Judge, District Court* and MEANOR, *District Judge*

The petition for rehearing filed by Nevada Power Company, Iowa Electric Light & Power Company, Iowa Power & Light Company, Oklahoma Gas & Electric Company, Southwestern Electric Power Company, Carolina Power & Light Company, South Carolina Electric & Gas Company, Virginia Electric and Power Company, Southern Electric System, Edison Electric Institute, Western Coal Traffic League, American Paper Institute, Inc. and The National Industrial Traffic League in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

By the Court,

/s/______________________________

JOHN J. GIBBONS
Circuit Judge

Dated: Nov 15 1982

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*Hon. Clarkson S. Fisher, Chief Judge, United States District Court for the District of New Jersey, sitting by designation.

*Hon. H. Curtis Meanor, District Judge for the District of New Jersey, sitting by New Jersey.

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 81-1492, 81-2633, 81-2634, 81-2635, 81-2636, 81-2637, 81-2638 and 81-2859

BESSEMER AND LAKE ERIE RAILROAD COMPANY,

Petitioner

Alabama Power Co., et al., Petitioners in No. 81-1493; Chemical Man. Assoc. Petitioner in No. 81-2634; Edison Electric Institution, Petitioner in No. 81-2635; American Paper Institute, Petitioner in No. 81-2636; Association of American Railroads, Petitioner in No. 81-2638; Iowa Electric Light & Power Co., et al., Petitioners in No. 81-2638; Western Coal Traffic League, Petitioner in No. 81-2859

v.

INTERSTATE COMMERCE COMMISSION AND UNITED STATES OF AMERICA,

Respondents

Association of American Railroads, et al., Intervenors in No. 81-1493; Western Coal Traffic League, et al., Intervenors in Nos. 81-2633/8; Carolina Power & Light Co., et al., Intervenors in No. 81-2859;
(ICC Ex Parte No. 393)

ON PETITION FOR REVIEW OF AN ORDER OF THE INTERSTATE COMMERCE COMMISSION*

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*[Abbreviated Caption]

Present: GIBBONS, *Circiut Judge*, FISHER,* *Chief Judge, District Court* and MEANOR,* *District Judge*

JUDGMENT

These causes came on to be heard on the record from the Interstate Commerce Commission and were argued by counsel on September 20, 1982.

On consideration whereof, it is now here ordered and adjudged by this Court that the said petition be, and the same is hereby denied and the decision of the said Commission, Ex Parte 393, 364 I.C.C. 803 (1981), dated March 26, 1981, and served March 30, 1981, be, and the same is hereby affirmed in all respects. Costs taxed against petitioners.

ATTEST:

/s/____________________

SALLY MRVOS
Clerk

October 19, 1982

Certified as a true copy and issued in lieu of a formal mandate on December 3, 1982.

/s/____________________

M. ELIZABETH FERGUSON
Chief Deputy Clerk, United States Court of Appeals for the Third Circuit

Costs taxed in favor of Association of American Railroads (Intervenor-Resp.) as follows:

Appendix	$348.33
Brief	568.40
TOTAL	$916.73

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*Honorable Clarkson S. Fisher, Chief Judge, and Honorable H. Curtis Meanor, District Judge, United States District Court for the District of New Jersey, sitting by designation.

APPENDIX E

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 81-1492, 81-2633/38 and 81-2859

BESSEMER AND LAKE ERIE RAILROAD COMPANY

v.

INTERSTATE COMMERCE COMMISSION and UNITED STATES OF AMERICA

OPINION ON DENIAL OF MOTION FOR RECALL OF MANDATE

Submitted Under Third Circuit Rule 12(6)
January 25, 1983

Before: GIBBONS, *Circuit Judge*, FISHER and MEANOR, *District Judges**

(Opinion Filed: January 26, 1983)

JOHN F. DONELAN, ESQ.
FREDERIC L. WOOD, ESQ.
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*Hon. Clarkson S. Fisher, Chief Judge, and Hon. H. Curtis Meanor, District Judge, for the District of New Jersey, sitting by designation.

GIBBONS, *Circuit Judge*.

Certain petitioners in the above entitled case move to recall the mandate of this court and to schedule the case for reargument. Our judgment was entered on October 19, 1982, petitions for rehearing were denied by order dated November 2, 1982, and a certified judgment in lieu of mandate issued on December 3, 1982. The ground asserted in support of the motion is that by Section 103(b) of the Federal Courts Improvement Act of 1982, Public Law 97-164, 96 Stat. 25, April 2, 1982, 28 U.S.C. §46(b) was amended to provide:

> In each circuit the court may authorize the hearing and determination of cases and controversies by separate panels each consisting of at least three judges at least two of whom shall be judges of that court, unless such judges cannot sit because recused or disqualified, or unless the chief judge of that court certifies that there is an emergency including, but not limited to, the unavailability of a judge of the court because of illness.

The moving parties point out that in this instance the panel included two judges of the United States District Court for the District of New Jersey.

When the petitions were filed the Clerk of this Court, pursuant to the court's standard practice, circulated copies of the docket sheets to determine whether or not members of the court were recused pursuant to 28 U.S.C. §455. All active judges except Judge Gibbons indicated that they were disqualified. In addition, Senior Judges Van Dusen and Rosenn indicated disqualification. Senior Judge Albert B. Maris does not ordinarily sit in cases requiring oral argument. The court was aware of the provisions of Public Law 97-164, and of its effective date of October 1, 1982. Since, however, only one member of the court was eligible to hear the cases, on August 12, 1982 Chief Judge Seitz, pursuant to 28

U.S.C. §292(a), designated Chief Judge Clarkson S. Fisher and Judge H. Curtis Meanor to hear them. Orders containing those designations are on file in the Office of the Clerk of this Court.

The motion to recall the mandate and to schedule the cases for reargument will be denied.

A True Copy:

Teste:

*Clerk of the United States Court of Appeals
for the Third Circuit*

No. 82-1369

In the Supreme Court of the United States

OCTOBER TERM, 1982

WESTERN COAL TRAFFIC LEAGUE, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENTS IN OPPOSITION

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LAWRENCE H. RICHMOND
Deputy Associate General Counsel

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Washington, D.C. 20430

QUESTIONS PRESENTED

1. Whether the Interstate Commerce Commission's adoption, as the standard for railroad revenue adequacy, of a rate of return on net investment equal to the current cost of capital was consistent with 49 U.S.C. 10704(a)(2) and constituted a reasonable exercise of discretion.

2. Whether the Commission's definitions of cost of capital and net investment base were arbitrary and capricious.

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In the Supreme Court of the United States

OCTOBER TERM, 1982

No. 82-1369

WESTERN COAL TRAFFIC LEAGUE, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENTS IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-35a) is reported at 691 F.2d 1104. The decision of the Interstate Commerce Commission (Pet. App. 1b-24b) is reported at 364 I.C.C. 803.

JURISDICTION

The judgment of the court of appeals was entered on October 19, 1982 (Pet. App. 1d-2d), and petitions for rehearing were denied on November 15, 1982

(Pet. App. 1c-2c). The petition for a writ of certiorari was filed on February 14, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Congress enacted the Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31 (the "4R Act"), in the face of a sea of bankruptcies involving most railroads serving the northeastern United States. Intervention by the Interstate Commerce Commission into railroad rate-making was perceived as a major contributor to the carriers' weakened financial position, and Congress sought to restore stability by reducing regulatory restraints on rail carrier pricing decisions. See S. Rep. No. 94-595, 94th Cong., 2d Sess. 134 (1976). Thus, the 4R Act substantially limited the power of the Commission to find rates unreasonably high or low, and restricted the Commission's power to suspend rate changes. 4R Act, Section 202(b) and (e), 90 Stat. 35, 36-38.

The 4R Act also directed the Commission to develop and promulgate reasonable standards for the establishment of adequate railroad revenue levels, and then to make "an adequate and continuing effort to assist those [rail] carriers in attaining [the] revenue levels prescribed * * *." 4R Act, Section 205, 49 U.S.C. (Supp. IV) 10704(a)(2) * * *.[1] The Act

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[1] The provision enacted by the 4R Act was originally codified at 49 U.S.C. 15a(4). That provision was restated without substantive change as 49 U.S.C. (Supp. IV) 10704(a)(2) by the Act of Oct. 17, 1978, Pub. L. No. 95-473, 92 Stat. 1337. See H.R. Rep. No. 95-1395, 95th Cong., 2d Sess. 70, 72 (1978). The excerpt quoted above is from the restated provision as it appears in 49 U.S.C. (Supp. IV) 10704(a)(2).

carefully specified that the revenue levels established by the Commission as adequate must be sufficient to "support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, * * * cover the effects of inflation * * * [and] attract and retain capital in amounts adequate to provide a sound transportation system in the United States." *Ibid.* Congress did not, however, give carriers whose revenues were determined to be inadequate any regulatory freedoms unavailable to "revenue adequate" carriers, or specify how the Commission was to use its revenue adequacy findings in individual rate proceedings.

Pursuant to the 4R Act, the Commission began an extensive rulemaking proceeding to devise standards of revenue adequacy. *Establishment of Adequate Railroad Revenue Levels*, 358 I.C.C. 844, modified, 359 I.C.C. 270 (1978) (*Ex Parte No. 338*). Upon promulgation of generic standards, the Commission conducted a proceeding to make revenue adequacy determinations for individual railroads. See *Adequacy of Railroad Revenue*, 361 I.C.C. 79 (1978), and 362 I.C.C. 198 (1979), petition for reopening denied, 362 I.C.C. 794 (1980) (*Ex Parte No. 353*).

Rather than adopting a single standard of revenue adequacy in these proceedings, the Commission defined a range between a minimum and a maximum standard. The minimum standard was determined by using the "flow of funds" approach, advocated by shipper groups (including several of the petitioners herein). This method was designed to measure the revenues required to (1) pay all operating expenses and contractual debt obligations, and (2) provide enough equity capital from retained earnings to permit financing of all necessary future investments at the current cost of capital for debt and equity. *Ex*

Parte No. 338, *supra*, 358 I.C.C. at 859-860; *Ex Parte No. 353*, *supra*, 362 I.C.C. at 204, 227-242. The maximum standard for revenue adequacy was defined as the "fair return level"—*i.e.*, a rate of return equal to the cost of capital multiplied by the net investment base. *Ex Parte No. 338*, *supra*, 358 I.C.C. at 896; 359 I.C.C. at 273; *Ex Parte No. 353*, *supra*, 362 I.C.C. at 223-224. In addition, the Commission proposed to give weight to a number of financial indicators in determining the revenue adequacy of individual carriers; where a carrier's revenues fell within the range, these indicators would be used in making a judgment regarding revenue adequacy. 358 I.C.C. at 858-860.[2]

The railroad industry continued to struggle financially despite the 4R Act reforms, prompting Congress to enact the Staggers Rail Act of 1980,[3] Pub. L. No. 96-448, 94 Stat. 1895 ("Staggers Act"). The

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[2] Using these standards, the Commission found 13 carriers with rates of return ranging from 4.02 to 11.70 percent to be revenue adequate, and 23 carriers with rates of return ranging from -40. to 4.65% to be revenue inadequate. 362 I.C.C. at 297-341.

[3] For example, during this period, two major midwestern rail carriers—the Chicago, Rock Island & Pacific Railroad and the Chicago, Milwaukee, St. Paul and Pacific Railroad—not only declared bankruptcy, but ceased providing service over the major parts of their systems, forcing congressional intervention. See Rock Island Transition and Employee Assistance Act, Pub. L. No. 96-254, 94 Stat. 399; Milwaukee Railroad Restructuring Act, Pub. L. No. 96-101, 93 Stat. 736. Two other major carriers—Consolidated Rail Corporation and the Delaware & Hudson Railroad—required major government subsidies. U.S. Railway Ass'n, *Conrail at the Crossroads: The Future of Rail Service in the Northeast* 2, 39 (1981). See also the Commission's initial revenue adequacy determinations in *Ex Parte No. 353*, 362 I.C.C. at 257.

express purpose of the new legislation was "to provide for the restoration, maintenance, and improvement of the physical facilities and financial stability of the rail system of the United States." Section 3, 94 Stat. 1897, 49 U.S.C. (Supp. IV) 10101a, note. This financial and physical improvement was to be accomplished primarily through further limiting of federal regulation of railroad ratemaking and through encouraging the earnings levels necessary to attract needed capital. H.R. Rep. No. 96-1430, 96th Cong., 2d Sess. 79-80 (1980).

In the Staggers Act, the Commission once more was directed to complete a proceeding—this time within 180 days—to establish standards of revenue adequacy and to determine which railroads were meeting those standards. Section 205(b)(2), 49 U.S.C. (Supp. IV) 10704(a)(3) and (4). Additional such proceedings were to be conducted in subsequent years. The Staggers Act also directed the Commission to consider revenue adequacy in any proceeding involving the reasonableness of a railroad rate. Section 201(a), 49 U.S.C. (Supp. IV) 10701a (a)(3). Only railroads not earning adequate revenues would have the right, after 1984, to increase rates by 4% per year without those increases being subject to suspension (Section 203(a), 49 U.S.C. (Supp. IV) 10707a(d)(3) and (e)), and only railroads not earning adequate revenues would have the right to impose surcharges on all traffic moving under joint rates (Section 217(a)(1), 49 U.S.C. (Supp. IV) 10705a(a) and (b)). Under this statutory scheme, then, a finding of revenue adequacy would narrow the ratemaking flexibility of the carrier involved.

2. a. Faced with these congressional directives, the Commission instituted the proceeding that is the subject of the instant petition. *Ex Parte No. 393*,

Standards for Railroad Revenue Adequacy, 45 Fed. Reg. 80150-80155 (1980). The Commission proposed that, in light of the emphasis of the Staggers Act on revenue adequacy, the then-existing standards should be replaced. Under the proposed standards, revenues would be deemed adequate if a railroad earned a rate of return on investment equal to the current cost of capital, and if the railroad achieved certain financial ratios consistent with a sound financial condition. The Commission proposed to withdraw the "funds-flow" standard. 45 Fed. Reg. 80151-80152 (1980).

After consideration of voluminous comments filed by railroad and shipper interests, the Commission promulgated its current revenue adequacy standards. *Standards for Railroad Revenue Adequacy*, 364 I.C.C. 803 (1981) (Pet. App. 1b-24b) ("*Ex Parte No. 393*"). The Commission found (Pet. App. 7b-8b) that the most appropriate standard for determining if a railroad has adequate revenues is whether it receives a rate of return equal to the current cost of capital. This rate of return was deemed the minimum rate of return that would allow railroads to obtain investment funds, because, in the Commission's judgment, "investments earning less than the cost of capital will, in general, not maintain existing funding nor obtain new funding" (*id.* at 8b).

The Commission also stressed that a rate of return equal to the current cost of capital would satisfy all of the statutory criteria, because it would give carriers a " 'flow of net income sufficient to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, cover the effect of inflation' and otherwise meet the requirements of the statute" (Pet.

App. 8b, quoting 49 U.S.C. (Supp. IV) 10704(a)(2)(A)).

b. Having adopted this standard for determining revenue adequacy, the Commission next defined the relevant cost of capital as a weighted average of the current cost of debt and equity. The Commission rejected the shippers' contentions that the embedded cost of debt, reflecting the historical cost of prior investment, should be used. The Commission explained, repeating the analysis provided in the Notice of Proposed Rulemaking (Pet. App. 13b):

> A sound transportation system should return the cost of capital to investors and reflect that cost of capital in prices paid by users. These are forward-looking concepts. The year and the rate at which past debt was raised are not ~~revelant~~ RELEVANT for these purposes. The more relevant consideration is the cost to the railroad of raising (or not losing) capital for current and future investment.

The Commission did not exclude unused and non-useful assets from the initial calculation of the net investment base, finding that to do so would be impractical in the 180-day period available to complete the initial proceeding and that only minimal distortions would result in any event (Pet. App. 10b). The Commission also determined that reserves for deferred taxes that would have been due had the railroads not used the accelerated rather than straight-line depreciation method for tax purposes should not be subtracted from the investment base.

3. The court of appeals affirmed the Commission's decision in all respects.[4] The court held that the "over-

[4] A cross-petition filed by several railroads, objecting to the Commission's statement that it would, in a future pro-

all policy pursued by the agency [in adopting a single rate-of-return standard] is entirely consistent with Congressional directives," and that the "[r]easons for departure from the ICC's prior position with respect to use of financial ratios and flow of funds analysis, and for refraining from incorporating productivity standards * * *, have been carefully explained" (Pet. App. 26a). The court further concluded that the agency's use of the current (rather than embedded) cost of debt was consistent with the statute (*id.* at 28a-29a), and that the agency had adequately explained the inclusion of both unused and unuseful assets and the reserve for deferred taxes in the investment base (*id.* at 31a, 33a).

ARGUMENT

The court of appeals correctly determined that the Commission's revenue adequacy standards are consistent with the statutory scheme and supported by the Commission's analysis. The decision conflicts with no decision of this Court or of any court of appeals, and does not warrant further review.

1. Petitioners urge (Pet. 9-13) that the revenue adequacy standards adopted in *Ex Parte No. 393* raise important questions concerning the Commission's regulation of rail rates, because, in petitioners' view, the standards deprive captive rail shippers of the maximum rate protections provided in the Interstate Commerce Act. This argument confuses the distinct issues of defining revenue adequacy, on the one hand, and utilizing the concept of revenue adequacy in ratemaking decisions, on the other. Only the Com-

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ceeding, consider excluding "unused and nonuseful assets" from the investment base, was denied as not ripe for judicial review (Pet. App. 33a-34a).

mission's definition of revenue adequacy is at issue in this case.

The purpose of both the 4R Act and the Staggers Act was to help rehabilitate and maintain the physical facilities of the railroad industry and to restore its financial integrity. 4R Act, Section 101(a), Pub. L. No. 94-210, 90 Stat. 33; Staggers Act, Section 3, Pub. L. No. 96-448, 94 Stat. 1897. Thus, because revenue adequacy findings must be considered in rate proceedings and can limit a carrier's access to several Staggers Act reforms, revenue adequacy must be carefully defined to ensure that no carrier is labeled revenue adequate unless its revenues are "adequate" for the purposes Congress sought to achieve: the obtaining of long-term financing for the rehabilitation and maintenance of that carrier's physical plant.

Contrary to petitioners' contention, however, the Commission's definition of revenue adequacy does not have the effect of "depriving captive rail shippers of the maximum rate protections which Congress intended them to have" (Pet. 9). Individual rates, or methods that may be used to determine individual rates, are not at issue here. Although the Commission is required to "consider" revenue adequacy in individual rate cases (49 U.S.C. (Supp. IV) 10701a (b)(3)), the Commission's decision in this case does not determine or even discuss what form that consideration might take. Accordingly, the decision below does not preclude shippers from seeking relief from unreasonable rates charged by carriers even if those carriers are determined to be revenue inadequate. Indeed, both the Commission and the court of appeals stressed that "a revenue adequacy determination is no guarantee that any carrier will attain any level of revenue" (Pet. App. 6b, 7b, 27a).

Petitioners apparently believe that the Commission has given undue weight to carrier revenue needs in the concededly "few" individual rate cases decided after the Commission rendered the decision at issue here. They point (Pet. 11) to several individual rate cases in which revenue inadequacy was considered.[5] Petitioners' argument regarding the methods used in individual rate cases has no relevance here. None of these cases is now before the Court, and petitioners' objections with respect to them may be raised in actions seeking judicial review in those cases. This case, as we have said, concerns only the Commission's definition of revenue adequacy.[6]

Petitioners also contend (Pet. 13) that the standard adopted by the Commission must be erroneous because it results in a finding of revenue inadequacy for many railroads and, hence, no "meaningful distinction" is made between financially strong and weak railroads.

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[5] All but one of these cases involved carriers whose revenues were inadequate under both the new standards adopted by the Commission in the instant proceedings and the old standards. The exception is the *Chesapeake & Ohio Ry.*, Docket No. 38793, petition for review of a decision of the Public Service Comm'n of West Virginia (served Mar. 18, 1982), appeal docketed, No. 82-3122 (3d Cir.), *Wheeling Pittsburgh Steel Co.* v. *ICC*.

[6] Similarly, the Commission's *proposed* guidelines for taking revenue adequacy into account in ratemaking proceedings, set forth in a notice in *Ex Parte No. 347 (Sub-No. 1), Coal Rate Guidelines—Nationwide* (served Feb. 24, 1983), discussed in the Brief Amicus Curiae filed by the Consumer Owned Power Coalition (at 18-22), may be contested in an action challenging those guidelines if they are finally adopted by the Commission or in an action contesting individual rates determined by reference to the proposed or final guidelines. Those guidelines do not furnish a basis for reviewing the revenue adequacy standards themselves in this case.

The purpose of the Staggers Act, however, was not to require the Commission to determine which carriers have more adequate or less adequate revenues on a relative basis. Rather, it required the Commission to define revenue adequacy at levels sufficient to "attract and retain capital in amounts adequate to provide a sound transportation system." 49 U.S.C. (Supp. IV) 10704(a)(2)(B). Further, Congress made explicit findings in the Staggers Act that earnings of the railroad industry as a whole were "insufficient to generate funds for necessary capital improvements" and that "by 1985, there will be a capital shortfall within the railroad industry of between $16,000,000,000 and $20,000,000,000." Staggers Act, Section 2, 94 Stat. 1896. Given these findings, Congress could not have anticipated that the Commission would find large numbers of carriers to be revenue adequate. See Pet. App. 15b-16b.[7]

2. The court of appeals correctly rejected petitioners' contention (Pet. 14-18) that 49 U.S.C. (Supp. IV) 10704(a)(2) "expressly precluded" the Commission from adopting return on investment as the sole measure of revenue adequacy. As its terms make clear, 49 U.S.C. (Supp. IV) 10704(a)(2) does not require the Commission either to adopt or to avoid any particular method for determining revenue adequacy. Rather, the statute lists several performance tests for

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[7] Petitioners cite (Pet. 13) the Burlington Northern Railroad (BN) as an example of a strong railroad that should be considered revenue adequate, because it had the resources recently to acquire control of El Paso Natural Gas Company. Contrary to petitioners' contention, however, BN's decision to invest internally generated funds outside the rail industry in fact does not speak well for the profitability of BN's rail operations. Moreover, BN was considered revenue inadequate even under the old standards that petitioners now seek to have reinstated. See *Ex Parte No. 353, supra,* 362 I.C.C. at 303.

carrier revenue adequacy, and requires the Commission to design standards that would enable railroads to satisfy those tests. Thus, Section 10704(a) provides:

> The Commission shall maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers * * * that are adequate, under honest, economical, and efficient management, to cover total operating expenses, including depreciation and obsolescence, plus a reasonable and economic profit or return (or both) on capital employed in the business.

Further, the revenue levels established by the Commission must—

> (A) provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation; and (B) attract and retain capital in amounts adequate to provide a sound transportation system in the United States.

The Commission found that a rate of return on investment equal to the current cost of capital would satisfy all of these performance criteria (Pet. App. 7b-9b). The Commission credited the testimony of a witness in the proceedings, Professor Baumol, that any decision which precluded a compensatory return on a railroad's cost of capital would result in disinvestment from the railroad industry, because investors would choose to invest their funds elsewhere at a higher rate of return (Pet. App. 7b-8b). Such disinvestment in turn would lead to deterioration of plant and equipment, avoidance of replacement of equipment, neglect of opportunities for moderniza-

tion, and withdrawal of railroad services valued by customers. In contrast, the Commission concluded that the rate-of-return standard would prevent these results, and thus was entirely consistent with congressional directives.[8]

Petitioners contend (Pet. 17), however, that the Commission did not explain its departure from its prior position, expressed in *Ex Parte No. 338*, that it would look to factors beyond the rate of return in determining revenue adequacy. See *Ex Parte No. 338*, *supra*, 358 I.C.C. at 858-860; *Ex Parte No. 353*, *supra*, 362 I.C.C. at 216. This contention is without

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[8] Contrary to petitioners' contention (Pet. 16-17), the opinion of the District of Columbia Circuit in *San Antonio* v. *United States*, 631 F.2d 831, 850 n.104 (D.C. Cir. 1980), modified, 655 F.2d 1341 (1981), rev'd on other grounds *sub nom. Burlington Northern, Inc.* v. *United States*, No. 81-1008 (Dec. 13, 1982), supports rather than undermines the Commission's and court of appeals' decision. The court there stated that although 49 U.S.C. (Supp. IV) 10704(a)(2) reveals that revenue levels must provide net income adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, and permit the raising of needed equity capital, "that language specifies not at all the exact methodology that the Commission shall use in accomplishing the mandate." 631 F.2d at 850 n.104. The court likewise rejected the city's reliance upon the same Senate Report relied upon by petitioners herein (Pet. 15, quoting S. Rep. No. 94-499, 94th Cong., 2d Sess. 51-52 (1975)); it noted that although the Report indicates that the Commission should not focus solely on rate-of-return analysis and should adopt a prospective view of revenue needs, the Report does not prescribe the specific standards by which to determine the adequacy of revenue levels. 631 F.2d at 850 n.104. Here, the Commission did not focus solely on rate of return. It explicitly considered the other statutory criteria of adequacy and determined that a rate-of-return standard would assure sufficient income to meet those criteria (Pet. App. 86-96).

merit. The Commission explained that in *Ex Parte No. 338* and *Ex Parte No. 353*, it had established a range of revenue adequacy, with a high value to be determined by looking to the cost of capital and a low value to be determined by using a flow of funds model. The Commission stated that flow of funds determinations "represent *minimum* target levels to be achieved" and "are appropriate as indicators only of the short-term viability of railroads" (Pet. App. 6b (emphasis added)). These indicators, the Commission explained, were "never intended to define a long-term level of adequate revenue" (*id.* at 5b), and "are especially inappropriate as measures to limit rail pricing flexibility which is one of the roles the [Staggers] Rail Act accords revenue adequacy findings" (*id.* at 6b). The Commission continued (*ibid.*):

> If we adopted the Ex Parte No. 353 minimum or short-term standard for use here, we would likely in the next few years find ourselves denying a railroad the pricing flexibility necessary to obtain long-term revenue adequacy simply because that railroad was making some progress toward achieving that goal. In short, we would be assigning the railroads the Sisyphean task of working toward revenue adequacy, and every time it came close robbing it of the very means it had used to get there. We do not believe this is desirable nor do we believe it was intended by Congress. Thus, our adoption of a rate of return standard is not a radical departure from our previous standards. Ex Parte No. 353 clearly accepted rate of return as a proper standard for ascertaining if a railroad has actually earned adequate revenues. In adopting such a standard here, we are only adapting our earlier findings to the mandate and policy of the [Staggers] Rail Act.

Finally, the Commission stressed that a finding of revenue inadequacy does not give a railroad license to set rates at unreasonable levels, because "revenue need is not the only factor to be considered when the reasonableness of a rate is determined" (*id.* at 7b). As a result, "the computation of an adequate revenue level for the carrier does not represent a guarantee that the carrier will attain such a revenue level" (*ibid.*).

The court of appeals held that the "[r]easons for departure from the ICC's prior position with respect to use of financial ratios and flow of funds analysis * * * have been carefully explained" (Pet. App. 26a).[9] The Commission therefore satisfied its responsibility to explain its change of policy. Cf. *Atchison T. &*

[9] Petitioners contend (Pet. 17) that the Commission had taken the position in its decisions in *Ex Parte No. 338* and *Ex Parte No. 353* that 49 U.S.C. (Supp. IV) 10704(a)(2) prohibited the Commission from adopting a single standard of revenue adequacy and that the Commission therefore erred in not explaining why its legal position on this question of statutory construction had changed. However, as a reference to the pages of the Commission's decisions relied upon by petitioners makes clear, the Commission did not rest its decisions on a conclusion that the statute precluded it from settling on one measure of revenue adequacy; it simply described why it determined that consideration of other factors was appropriate. See 358 I.C.C. at 858-859; 362 I.C.C. at 216. The Notice of Proposed Rulemaking in *Ex Parte No. 338* did state that what is now Section 10704(a)(2) does not envision that rate of return will be the sole factor to be considered in judging revenue adequacy. See 358 I.C.C. at 904. But the Commission did not take a contrary view here; it considered the other statutory factors and determined that they would be satisfied by using rate of return as a measure of the revenues that would be necessary to accomplish the statutory purpose.

S.F. R. v. *Wichita Board of Trade*, 412 U.S. 800, 808-809 (1973) (plurality opinion of Marshall, J.).

3. Petitioners object (Pet. 19-20) because the Commission included "unused and non-useful" assets in the net investment base. This objection is insubstantial, especially in this case. Throughout these proceedings the Commission actually has agreed that it should seek to eliminate unused and unuseful assets from the investment base when it is feasible to do so. But the Commission also recognized that the identification of unused and unuseful assets is a complex and controversial task that could not be performed within the 180-day period allowed by Congress for completion of the initial revenue adequacy determination (*ibid.*). Further, the Commission found that including unused and unuseful assets in the initial investment base would cause only a "minor distortion," because these assets amount to significantly less than 1% of total net investment [10] and because the railroads with the highest percentage of unused and unuseful assets are the least profitable and therefore are the least likely to be found revenue adequate in any event (*id.* at 10b). The court of appeals found evidence in the record to support these findings, and on this basis correctly concluded that "no adjustment to the book values of the investment base [to reflect unused and unuseful assets] was necessary at this

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[10] Petitioners attempt to show the significance of this issue by referring (Pet. 20 n.14) to a railroad witness' estimate that there are $225 million in unused and unuseful property. This figure was derived using the generous and questionable assumption that the book value per mile of unuseful property is equal to the average book value per mile of all railroad property. Even so, this estimated total amounted to only .79% of railroad net investment.

time, because no likelihood of substantial over-valuation was established" (*id.* at 31a).

This issue may soon be mooted in any event, because the Commission recently proposed a number of substantial changes to improve the accuracy of its initial revenue adequacy standards. One of these proposals is "Elimination of Assets that are not used and useful from the investment base." *Ex Parte No. 393 (Sub-No. 1), Standard for Railroad Revenue Adequacy* (Mar. 9, 1983), slip op. 2. In these circumstances, the Commission's inclusion of these assets presents no issue warranting this Court's review.

4. Petitioners attack (Pet. at 20-21) the Commission's decision to use the current cost of debt, rather than the embedded cost of debt, in computing the adequate rate of return on carrier net investment. Petitioners claim that the Commission's approach overstates debt costs because, at the present time, the current cost of debt substantially exceeds the carrier's contractual interest and principal repayment requirements.

Contrary to the premises underlying petitioners' contention, however, "revenue adequacy" for purposes of 49 U.S.C. (Supp. IV) 10704(a) is a long-run and forward-looking concept. The Commission must establish revenue levels adequate to "attract and retain capital in amounts adequate to provide a sound transportation system" in the future (49 U.S.C. (Supp. IV) 10704(a)(2)(B)), rather than merely measure the historical profitability of a carrier or that carrier's ability to repay the debt associated with past investments. Moreover, as the Commission found (Pet. App. 13b), if a railroad attempts to raise capital today, either to rebuild worn-out facilities or to expand existing facilities, it must compete for scarce investment funds. To do so, it must offer a rate of

return equal to the cost of capital, where the cost of capital is the weighted average of the current cost of debt and the current cost of equity capital. Conversely, and as noted by the court of appeals, "[i]f the railroads could not gain a rate of return on investment represented by old debt in excess of the old interest rates on such debt, they would be unlikely to attract new equity capital, and their shareholders would insist on investment of internally generated funds outside the rail industry" (*id.* at 28a).

The Commission's choice of the current cost of capital also cannot be divorced from its choice of an original cost investment base or its obligation to promulgate standards that "cover the effects of inflation." 49 U.S.C. (Supp. IV) 10704(a)(2)(A). The Commission was aware that the current and embedded cost of debt differ largely because the inflation rates anticipated by current and past investors differ.[11] Similarly, the Commission was aware that, in times of inflation, historical cost accounting systems using actual "embedded" costs fail to reflect the impact of changing prices on asset values and expenses. As a result, such systems tend to understate operating expenses (especially depreciation) and result in the reporting of illusory profits.[12] In the instant proceeding,

[11] "The nominal cost of capital is the sum of the real cost of capital and the expected rate of inflation" (Pet. App. 12b).

[12] The Commission recently elaborated:

> Historical cost depreciation is viewed as a systematic method for allocating asset costs over useful lives. However, during periods of inflation, this cost does not reflect the economic cost consumed. Thus, while reported earnings of a company often increase during periods of inflation, the increases are not necessarily real. To maintain operating capability, for example, a railroad must

the Commission was forced to use an original cost valuation of the investment base because replacement data were unavailable (Pet. App. 17b). The Commission then selected the current nominal cost of capital as the proper rate of return standard, noting wide acceptance for the proposition that "the nominal cost of capital must be applied to an original cost-based asset valuation if the railroads are to be compensated for inflation" (*id.* at 12b); see *Ex Parte No. 393* (Notice), 45 Fed. Reg. 80152 (1980). This was a rational response to the general problem of properly accounting for inflation.[13]

5. Finally, petitioners argue (Pet. 22-24) that the Commission should have excluded deferred taxes from the railroad's net investment base and that the court of appeals created a conflict among the circuits when it affirmed the Commission's treatment of deferred taxes.

Contrary to petitioners' contention, however, there is no conflict among the circuits regarding the validity of the Commission's current position. Each of the

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> continually replace productive assets at present costs. In periods of inflation, each replacement of an asset is more costly than its predecessor. Business continuity is not assured, therefore, merely because current revenues exceed past costs. While sales, earnings and dividends increase during inflationary periods, those increases do not necessarily represent gains in net worth in real terms.

Ex Parte No. 393 (Sub-No. 1) (Mar. 9, 1983), slip op. 7 (footnote omitted).

[13] The Commission reopened the entire issue of inflation accounting, including the choice of cost of capital and investment base, in *Ex Parte No. 393 (Sub-No. 1)*, *supra*. The Commission there proposed to withdraw the standards now under review and to replace them with a current cost valuation of the railroads' investment base and a "real" (adjusted for inflation) cost of capital rate of return.

three cases cited by petitioners [14] arose at a time when the Commission's revenue adequacy policy, as expressed in *Ex Parte No. 338*, *supra*, 358 I.C.C. at 889-894, required deduction of the deferred tax account from the net investment base. In each of the cited cases, the Commission apparently had failed to follow its own policy, and the courts simply remanded the cases to the Commission to "clarify whether this [deferred tax] adjustment was indeed appropriate and in fact performed." See, *e.g.*, *Cleveland-Cliffs Iron Co.* v. *ICC*, 664 F.2d 568, 586 (1981).[15] In a notice issued in *Ex Parte No. 347 (Sub-No. 1)*, *Coal Rate Guidelines—Nationwide*, 364 I.C.C. 360, 371 (1980), however, the Commission suggested that its *Ex Parte No. 338* policy should be changed, because it substantially reduced the incentive of railroads to undertake railroad investments, and thus thwarted "the intent of Congress in passing the Revenue Acts of 1954 and 1962, to provide business enterprise with tax benefits as a means of spurring capital spending."

The Commission adopted this reasoning in the instant proceeding, finding that "[i]f we exclude in-

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[14] *San Antonio* v. *United States*, *supra*, 631 F.2d at 847; *Iowa Public Service Co.* v. *ICC*, 643 F.2d 542, 546-547 (8th Cir. 1981); and *Cleveland-Cliffs Iron Co.* v. *ICC*, 664 F.2d 568, 586 (6th Cir. 1981).

[15] In *San Antonio* v. *United States*, the court of appeals expressed the view that under principles expressed in certain public utility rate cases, the deferred tax account should be deducted from the net investment base once normalization of taxes is elected. 631 F.2d at 847. As the court itself noted (*ibid.*), however, the Commission's policy at that time was to deduct deferred taxes, and the Commission had simply failed to follow that policy in the case under review. The D.C. court therefore had no occasion to review the Commission's revised policy, at issue in this case.

ternally generated funds, whether stemming from accelerated depreciation or any other railroad activity, from the investment base, the effect will be to establish a rate of return below the cost of capital" and "result in incentives to railroads to invest these funds in nonrail operations" (Pet. App. 11b). Against this background, the Commission adopted its new policy of including deferred taxes in the net investment base, accompanied by a careful explanation of its change from the prior policy.[16] The court of appeals correctly recognized that the cases decided under the Commission's old policy no longer apply (Pet. App. 33a & n.8), and found the Commission's new policy "rationally supported" and "consistent with the Congressional directive" (*ibid.*). The court of appeals' decision affirming the Commission's treatment of the deferred tax acount—the first decision addressing the Commission's new policy—does not warrant review by this Court.[17]

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[16] Petitioners claim the Commission's treatment of deferred taxes is inequitable because it permits the railroads to earn a return on investment capital "provided by the ratepayers" (Pet. 24) and not by railroad investors. The deferred tax account is not contributed by the ratepayers, however; if contributed by anyone, it is by the federal government, through authorization of accelerated depreciation for tax purposes. The Commission determined that its treatment of deferred taxes was consistent with the congressional purpose underlying accelerated depreciation of encouraging capital spending—a policy that also is consistent with the goals of the 4R and Staggers Acts.

[17] The Commission is again considering how tax benefits should be treated in computing revenue adequacy in order to reflect the impact of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172. See *Ex Parte 393 (Sub-No. 1)*, *supra*, slip op. 13.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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No. 82-1369

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

WESTERN COAL TRAFFIC LEAGUE, *ET AL.*,
Petitioners,

v.

UNITED STATES, *ET AL.*

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE ASSOCIATION OF AMERICAN RAILROADS IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the court of appeals erred in affirming the Interstate Commerce Commission's adoption of a single standard for determining the adequacy of railroad revenues which accomplishes all of the objectives of the governing provision of the Interstate Commerce Act.

2. Whether the court of appeals erred in upholding the Interstate Commerce Commission's choice of procedures to implement its standard for determining the adequacy of railroad revenues.

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BRIEF FOR THE ASSOCIATION OF AMERICAN RAILROADS* IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-35a) is reported at 691 F.2d 1104. The opinion of the Interstate Commerce Commission (Pet. App. 1b-24b) is reported at 364 I.C.C. 803.

*A list of the members of the Association of American Railroads is provided in the Appendix to this brief.

JURISDICTION

The judgment of the court of appeals was entered on October 19, 1982. Timely petitions for rehearing were denied on November 15, 1982. The petition for a writ of certiorari was filed on February 14, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATEMENT

For several decades, the Interstate Commerce Commission's regulation of railroads focused on protecting shippers and ignored the railroads' revenue requirements. This one-sided approach to regulation was a primary cause of the railroads' chronic financial difficulties.[1] In the aftermath of the bankruptcy of the Penn Central and several other railroads, which imperiled the industrial base of the Northeast and Midwest,[2] Congress passed a series of remedial acts, including the Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 94 Stat. 31 (1976) ("4R Act"), to enhance the financial viability of the nation's railroads. In section 205 of the 4R Act, Congress directly addressed the Commission's neglect of the railroads' revenue needs. It required the Commission to establish standards and procedures for assessing the adequacy of railroad revenues, and directed the Commission to "make an adequate and continuing effort to assist * * * carriers in attaining such revenue levels."[3]

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[1] *See* H.R. Rep. No. 96-1430, 96th Cong., 2d Sess. 89 (1980); S. Rep. No. 94-499, 94th Cong., 1st Sess. 2-4, 10-11 (1975).

[2] *See generally Regional Rail Reorganization Act Cases*, 419 U.S. 102, 107 (1974).

[3] Section 205 provided in pertinent part:

> [T]he Commission shall * * * develop and promulgate (and thereafter revise and maintain) reasonable standards and procedures for the establishment of revenue levels adequate under honest, economical, and efficient management to cover total operating expenses, including depreciation and obsolescence, plus a fair, reasonable, and economic profit or return (or both) on capital employed in the business. Such revenue levels should (a) provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repay-

The Commission conducted a series of rulemaking proceedings to implement section 205.[4] While acknowledging that ultimately the adequacy of railroads' revenues could be judged solely by reference to a competitive return on investment standard, the Commission adopted initial rules which gave it broad discretion to examine any "pertinent financial indicators" in making revenue adequacy determinations.[5] Applying these rules in a necessarily subjective manner, the Commission found that railroads earning a rate of return on their investment as low as four percent (which was less than half what the Commission determined to be a competitive return) had "adequate" revenues.[6] However, the Commission pledged to revise the rules as experience dictated.[7]

The financial plight of the railroad industry did not improve. Large government subsidies remained necessary to maintain rail service in the Northeast,[8] and two more major railroads went bankrupt. Faced with this continuing crisis, Congress passed emergency legislation.[9] In addition, Congress once again found

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ment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation, and (b) insure retention and attraction of capital in amounts adequate to support a sound transportation system in the United States. The Commission shall make an adequate and continuing effort to assist such carriers in attaining such revenues levels * * *.

[4]*See* Ex Parte No. 338, *Standards and Procedures for the Establishment of Adequate Revenue Levels*, 358 I.C.C. 844 (1978); Ex-Parte No. 353, *Adequacy of Railroad Revenue (1978 Determination)*, 362 I.C.C. 199 (1980).

[5]*See* Ex Parte No. 338, *supra*, 358 I.C.C. at 910; Ex Parte No. 353, *supra*, 362 I.C.C. at 216, 222-24. The rules were codified at 49 C.F.R. § 1109.25 (1978).

[6]Ex Parte No. 353, *supra*, 362 I.C.C. at 327-29.

[7]Ex Parte No. 338, *supra*, 358 I.C.C. at 896.

[8]*See Conrail Reauthorization: Hearings before the Subcomm. on Surface Transp. of the Comm. on Commerce, Science and Transp.*, Serial No. 97-13, 97th Cong., 2d Sess. 13 (1981).

[9]*Rock Island Transition and Employee Assistance Act*, Pub. L. No. 96-254, 94 Stat. 399 (1980); *Milwaukee Railroad Restructuring Act*, Pub. L. No. 96-101, 93 Stat. 736 (1979).

it necessary to revise the Interstate Commerce Act to mandate greater attention to the railroads' revenue needs. Congress enacted the Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895. In that Act, Congress found that without improved earnings, railroads would suffer a capital shortfall of 16 to 20 billion dollars by 1985, with disastrous effects on the nation's freight transport system. *Id.*, section 2. Congress therefore declared that it was its "overall purpose * * * to provide, through financial assistance and freedom from unnecessary regulation, the opportunity for railroads to obtain adequate earnings to restore, maintain and improve their physical facilities while achieving the financial stability of the national rail system." H.R. Rep. 96-1430, 96th Cong., 2d Sess. 80 (1980) (conference report).

In section 205 of this Act, Congress amended the revenue adequacy provision of the 4R Act by adding a directive for the Commisssion to "revise as necessary" its revenue adequacy rules, and to complete a proceeding for that purpose within 180 days. While Congress left it to the Commission to devise the proper means to give effect to the statute, Congress made it quite clear that the Commission's previous efforts had been unsatisfactory. For example, the House Commerce Committee stated in its report on the legislation that "previous admonitions by the Congress that the Commission assist carriers in earning adequate revenue levels (49 U.S.C. 10704) have not achieved their goals. As a result, the Committee is establishing a more straightforward mandate. This is a clear directive to ensure financially sound railroads." H.R. Rep. No. 96-1035, 96th Cong., 2d Sess. 54 (1980). The Senate Commerce Committee echoed this sentiment, stating that "the very positive substantive and far reaching changes of [the 4R Act] have not achieved their intended results * * *." S. Rep. No. 96-470, 96th Cong., 1st Sess. 5 (1979). And, in floor debate on the House bill, key Congressmen expressed their agreement with the observation of one member that the Commission's then effective rules had produced revenue adequacy thresholds which were so low as to be "totally unrealistic" and "ludicrous." Cong. Rec. H5998-99 (daily ed. July 2, 1980) (remarks of Reps. Harsha, Matsui).

In response to Congress' strengthened mandate, the Commission conducted a new rulemaking proceeding and decided, on the basis of expert testimony in an extensive administrative record, to adopt the single "cost of capital" standard of revenue adequacy (Pet. App. 5b). Under this standard, railroads are deemed to have adequate revenues when they earn a rate of return on their net investment competitive with returns available on other investments of similar risk.[10] The Commission also adopted procedures to implement this standard, including the use of original cost (less depreciation) as the measure of the investment on which railroads were to have the opportunity to earn a competitive return (Pet. App. 9b).[11]

Numerous shipper interests petitioned for review. They argued, *inter alia*, that the Interstate Commerce Act precluded the Commission from adopting a single standard of adequate revenues, and that the Commission was arbitrary and capricious and abused its discretion in its choice of procedures to measure the investment and the rate of return which railroads need the opportunity to earn on that investment. The Third Circuit court of appeals affirmed the Commission's order in a unanimous decision (Pet. App. 1a-35a), finding that the Commission had reasonably interpreted the Interstate Commerce Act, and had acted within its discretion in choosing between alternative means to implement the Act.

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[10]What actually constitutes a competitive return may vary over time. In the decision under review, the Commission found that 11.7 percent was a competitive return for the railroad industry in 1979 (Pet. App. 19b). The Commission has since updated that figure in annual rulemakings. *See* Ex Parte No. 416, *Railroad Revenue Adequacy – 1980 Determination*, 365 I.C.C. 285 (1981); Ex Parte No. 415, *Railroad Cost of Capital – 1981*, 365 I.C.C. 734 (1982); *see also* Ex Parte No. 436, *Railroad Cost of Capital – 1982*, 47 Fed. Reg. 33344 (1982).

[11]The Commission also expressed its intent to consider switching to replacement cost as the measure of railroad investment in a subsequent proceeding (Pet. App. 17b-18b). The Commission has in fact now initiated a rulemaking proceeding to adopt a replacement cost

ARGUMENT

The petition presents no issue warranting review by this Court. Congress established the policy that railroads need the revenues to attract additional capital and directed the Commission to establish objective standards for measuring that need. The court of appeals found that the Commission reasonably implemented Congress' policy.

Nevertheless, the shippers[12] feel that rates should not be as high as the appplication of the standard may allow and that some railroads need lower revenues than the standard might indicate. On the assumption that their feelings are correct, they conclude that the Commission has transgressed congressional policy and abdicated its duty to maintain reasonable rates. And on this basis, the shippers argue that this case "raises critical questions" (Pet. 9) warranting review by this Court.

However, the mere fact that this standard is inconsistent with the shippers' subjective impressions does not warrant review here. This is especially true since the possibility of higher rates was anticipated by Congress, and Congress has provided an independent process by which the Commission and the courts can determine whether any higher rates that may result from this standard are unreasonable.

The shippers also question the economic technicalities of the Commission's choice of methods to ensure that railroads have the opportunity to earn adequate revenues. These are all matters in which the Commission has broad discretion. The shippers have identified no flaw in the court of appeals' reasons for upholding the Commission's exercise of discretion. Moreover, the Commission is currently seeking to improve its technical implementation of Congress' mandate.

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method of asset evaluation and otherwise to modify its method of measuring a railroad's rate of return. *See* Ex Parte No. 393 (Sub-No. 1), *Standards For Railroad Revenue Adequacy*, 48 Fed. Reg. 10144 (1983).

[12] "The shippers" is used herein to refer to all of the parties which filed the petition for a writ of certiorari.

Finally, the shippers argue that the court of appeals' decision conflicts with decisions of other circuits in deferring to the Commission's choice of a method to achieve the purposes of a provision of the tax code designed to stimulate investment. But there is no conflict among the circuits, only a change in agency policy.

1. The shippers claim that the Commission has adopted a standard of adequate revenues that is much too high (Pet. 9). As proof, they assert that the difference between existing earnings levels and levels considered adequate under the standard is "immense," and that rates will have to increase dramatically to cover that difference (Pet. 9-13). Putting aside for the moment the uncertain relationship between this standard and individual rate reasonableness determinations, the fact that revenue levels under the standard may be significantly higher than existing revenue levels does not indicate that the standard is incorrect; it just as easily proves that existing revenue levels are woefully inadequate. Indeed, the latter conclusion is more consistent with the Staggers Act, in which Congress found that vastly higher earnings would be needed to restore the financial health of the railroad industry. *Id.*, sections 2(6), 2(7).

The shippers' position is reminiscent of the approach to rate regulation which Congress sought to eliminate when it enacted the 4R and Staggers Acts. Prior to those Acts, the Commission decided the reasonableness of rates essentially on an *ad hoc* basis, with no attention to overall carrier revenue needs. Based on its judgment that this approach had contributed to the decline of the railroad industry, Congress directed the Commission in those Acts to adopt an objective standard of adequate revenue levels for railroads, and made the attainment of those levels the only explicit standard governing rate reasonableness determinations. *See* 49 U.S.C. §§ 10701a(b)(3), 10704(a)(2). Thus, whereas determinations of the reasonableness of rates are now supposed to depend on the carrier's need for adequate revenues under an objective standard, the shippers are claiming in effect that a carrier's overall revenue opportunities should depend (as they did in the past) on subjective notions of the reasonableness of rates.

Even if the shippers correctly anticipate higher rates, there is no basis for their claim that higher rates are necessarily contrary to Congressional policy. The purpose of the Staggers Act was not to require the Commission to accord greater protection to shippers. Quite the contrary, while the Act preserved the Commission's powers to protect captive shippers,[13] Congress' primary concern was that the Commission had for too long been overly solicitous of shipper interests and too neglectful of the railroads' financial needs. Congress recognized that "earnings by the railroad industry are the lowest of any transportation mode and are insufficient to generate funds for necessary capital improvements," and that rate increases would be required to attract an additional 16 to 20 billion dollars by 1985. Staggers Act, *supra,* section 2. Moreover, Congress adopted the policy that "rail carriers *shall* earn adequate revenues," and made that policy the only explicit standard governing rate reasonableness determinations. 49 U.S.C. § 10701a(b)(3) (emphasis added). Thus, Congress plainly contemplated that the opportunity to earn revenues adequate to attract capital was consonant with the maintenance of reasonable, albeit higher, rates.

Congress not only anticipated that a proper revenue adequacy standard might allow higher rates, but it provided a process to ensure that any such rates would be reasonable. If the shippers are dissatisfied with the results of that process, they will have ample opportunities to seek redress. Thus, there is no basis for the argument that Supreme Court review is necessary to ensure

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[13]Staggers Act, *supra,* § 202, codified at 49 U.S.C. § 10709. Under this provision, the Commission's jurisdiction is preserved only in those instances where railroads have market dominance over their shippers. While it is well accepted that the number of such instances is relatively small compared to the total number of shippers served by railroads (*see* H.R. Rep. No. 96-1430, *supra,* at 92), the record below contains no evidence of what those instances are. Accordingly, there is no basis to accept the assertion (Pet. 7-8) that railroads have market dominance over most of the shippers who have challenged the Commission's decision.

that they receive "the maximum rate protections which Congress intended them to have" (Pet. 9).

As part of that process, the Commission is currently addressing the issue of how to protect shippers in another, ongoing rulemaking proceeding, Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines – Nationwide*. Shippers have an opportunity to shape the Commission's general rate policy in that proceeding.[14] In addition, whether any potentially higher rates for individual shippers would in fact be reasonable would be a matter for the Commission to decide in individual adjudications. The shippers would also be free to seek judicial review of any rule or individual rate decision.[15] Until the Commission actually makes those decisions, it would be beyond the province of this Court to determine *ex ante* the reasonableness of either the Commission's rate policy or any particular rate.[16]

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[14]In its decision served February 24, 1983, in that proceeding, the Commission essentially overruled the earlier statement of one of its administrative law judges cited by the shippers (Pet. 12) that no rate of a revenue inadequate carrier could now be found unreasonable. The Commission also stated (at p. 20) that it had not yet determined in which respects it will judge the reasonableness of rates of railroads not earning adequate revenues differently from those of railroads that are earning adequate revenues. Thus, it is premature to conclude whether the findings of revenue adequacy or inadequacy resulting from the application of the standard adopted by the Commission in this case will even matter once that proceeding is complete.

[15]Many shippers have already petitioned for review of the Commission's rulemaking proposal. *See Western Coal Traffic League v. United States*, No. 83-1204 (D.C. Cir.) and consolidated cases.

[16]Railroads profit more from hauling coal than from hauling alternative fuels, and therefore will continue to encourage the maximum use of coal, regardless of what the Commission might allow. For this reason, no prediction of the level of increases which might result from a more permissive rate regulation policy is possible without an understanding of the discrete market forces governing each separate rail coal service. Similarly, because railroads do not want to lose coal traffic, the petition raises no issue relating to the national energy policy of increased reliance on coal rather than alternative fuels such as imported oil.

2a. While the shippers are quite concerned that their rates may increase, they do not contest the economic soundness of the measure of a proper rate of return adopted by the Commission. Indeed, they have never identified an alternative basis to measure adequacy of revenues that could be applied objectively as a standard. (The Commission's prior rules, which the shippers evidently prefer, gave the Commission unfettered discretion to choose between numerous financial indicators.) Instead, they seek review on the grounds that the court of appeals erred as a matter of law in holding that the Commission could employ a single standard to determine adequacy of railroad revenues (Pet. 14-18). They contend that because the statute specifies other criteria which the standard must satisfy while allowing railroads the opportunity to earn a "reasonable and economic profit or return (or both) on capital employed in the business," the court should have held that the Commission was precluded from adopting "a rate of return on investment equal to the current cost of capital" as the standard of adequate revenues (Pet. 14). They cite several authorities, including a 4R Act Senate Report, dictum from a decision of the D.C. Circuit,[17] and prior statements of the Commission and a member of its staff, all of which state that a reasonable return on investment is not the only statutory objective which the revenue adequacy standards must address (Pet. 15-18).

The flaw in this argument is clear. As the court of appeals recognized (Pet. App. 23a-27a), nothing in the statute or any of these other authorities precluded the Commission from adopting "a single standard encompassing [all of] the objectives listed in section 205 * * * ." And that is precisely what the Commission did, after examining the record (Pet. App. 7b-9b). Since the shippers do not suggest that the Commission's rulemaking procedures were unfair, or that the record is inadequate to support the finding that the cost of capital standard gives effect to all of

[17]*San Antonio, Texas v. United States*, 631 F.2d 831, 850 n.104 (D.C. Cir. 1980), *clarified*, 655 F.2d 1341 (D.C. Cir. 1981), *rev'd on other grounds sub nom. Burlington Northern, Inc. v. United States*, ____ U.S. ____, 74 L. Ed. 2d 311 (1982).

the statutory objectives, this issue does not merit Supreme Court review.

The shippers' contention that by adopting this single standard the Commission altered its interpretation of the Interstate Commerce Act (Pet. 17-18) does not make this case any more appropriate for this Court's review.[18] This Court does not sit to review asserted conflicts in decisions of a single administrative agency. In any event, the court of appeals properly held that an agency has broad discretion to revise its policies, "so long as the policies it is pursuing can be discerned from its opinion, and those policies are consistent with congressional directives * * *" (Pet. App. 20a, citing *Atchison, T., & S.F. Ry. v. Wichita Bd. of Trade*, 412 U.S. 800, 809 (1973)). The court also found that it was reasonable for the Commission to revise its revenue adequacy standards and procedures in light of the Staggers Act's purpose to "create a regulatory environment more favorable to investment in railroads," and the Commission's experience with its prior rules (Pet. 25a-26a). There is no need for this Court further to scrutinize the integrity of the Commission's decision-making process, especially in light of the soundness of the end result of the Commission's order here.[19]

Finally, with regard to a single standard, the shippers argue that it was improper for the Commission to adopt a standard

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[18]The objection that "the Commission's decision did not even *address* the statutory question of whether Section 10704(a)(2) permitted the use of a single standard" (Pet. 17; emphasis in original) is easily answered. As the agency charged with administering a new statute, the Commission is entitled to great deference in its interpretation. *See Power Reactor Dev. Co. v. International Union of Electricians*, 367 U.S. 396, 408 (1961). It need not make explicit its ruling on every possible statutory issue, so long as the basis for its interpretation, as the court of appeals found, was reasonably discernable. *See Bowman Transp., Inc. v. Arkansas-Best Freight Sys., Inc.*, 419 U.S. 281, 286 (1974). This is especially the case here since no party in the rulemaking raised the single standard issue.

[19]The fact that the statute directs the Commission to "revise [its standards] as necessary" makes it especially inappropriate to fault the Commission for a change in position.

which looks to the adequacy of returns on investment, since "the 'used and useful' character of significant portions of this [investment] has been called into serious question" (Pet. 14). This objection does not go to the legitimacy of a single standard, but to the measurement of the investment base. In fact, however, the only evidence of record indicated that the amount of property that might be deemed unused and nonuseful was *de minimis* (Pet. App. 9b-10b). Moreover, this issue may soon be moot because the Commission has proposed a new method of valuing rail investment.[20]

b. The shippers also raise arguments concerning the Commission's procedures for implementing the cost of capital standard. As the court of appeals recognized, all of these points essentially involve "choice[s] by an agency among alternative means for satisfying a statutory mandate, [which are] exclusively for that agency" (Pet. App. 20a). *See, e.g., Bowman Transp., Inc. v. Arkansas Best Freight Sys., Inc.*, 419 U.S. 281, 285-86 (1974).

i. In an argument closely related to their objection to the Commission's use of a single standard, the shippers assert that the court of appeals erred in affirming the Commission's decision to include "unused and nonuseful assets" in the investment base on which railroads are to be permitted the opportunity to earn a return (Pet. 19-20). However, as the shippers themselves acknowledge (Pet. 20), neither the court nor the Commission disputed their position that those assets (which the shippers have never identified) should be excluded where practicable. The court merely held that the Commission's decision not to exclude the value of any unused and nonuseful assets in its initial revenue adequacy determination was not arbitrary, capricious, or an abuse of discretion, "because no likelihood of substantial overvaluation was established" (Pet. App. 31a).[21] Therefore,

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[20]See note 11, *supra*. Under the Commission's proposal, the possibility of any overstatement in investment values would be eliminated (see Pet. App. 10b).

[21]The shippers cite evidence submitted by the railroads showing the value of these assets to be less than $225 million (Pet. 20 n.14) but omit to note evidence that that amounts to no more than a fraction of

the error, if any, did not prejudice the shippers, and provided no basis for the court of appeals to reverse the Commission's order. *See* 5 U.S.C. § 706 (in reviewing agency decisions, "due account shall be taken of the rule of prejudicial error").[22]

ii. The shippers contest the court of appeals' holding that the Commission acted within its discretion in deciding to measure the current cost of capital by examining the current cost of debt (together with the current cost of equity), rather than the embedded cost of debt. Since the current cost of debt can exceed the embedded cost of debt, they argue that the Commission's decision conflicted with the statutory directive that revenue levels deemed adequate should "assure the repayment of a reasonable level of debt" (Pet. 20-21). This argument, which is premised on a serious misconstruction of the statute, provides no basis for review by this Court. The shippers do not argue that the standard adopted by the Commission will not "assure the repayment of a reasonable level of debt." Instead they argue, in effect, that the statute should be interpreted to read "earnings may not exceed a level sufficient to cover the embedded cost of debt." Nothing in the statute or Congress' policy requires that reading. As the court of appeals noted, "The specific objectives listed in Section 205 should not * * * be read as *limitations* on revenue * * *" (Pet. App. 25a; emphasis added).

In deciding to use the current cost of debt, which can obviously fall above *or* below the embedded cost of debt, the Commission was properly seeking to allow railroads the opportunity to earn an *overall* return on debt and equity that is competitive in current capital markets (Pet. App. 13b-14b). In af-

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one percent of total investment, which is about $27 *billion* (Pet. App. 10b, citing J.A. 316-17). In fact, the Commission has directly repudiated the suggestion that the investment figures on the railroads' books are significantly overstated (Pet. App. 10b).

[22]In any event, this issue may become moot when the Commission considers adopting its new method of asset valuation. See note 11, *supra*.

firming the Commission on this point, the court of appeals aptly noted that "[i]f the railroads could not gain a rate of return on investment represented by old debt in excess of the old interest rates on such debt, they would be unlikely to attract new equity capital, and their shareholders would insist on investment of internally generated funds outside the rail industry" (Pet. App. 28a). The shippers have identified no flaw in this reasoning. Thus, the Commission acted consistently with the capital attraction goal of Congress and there is no indication that the court of appeals failed to understand the issue.

iii. The shippers contest the court of appeals' affirmance of the Commission's decision not to reduce the railroads' investment bases by the amount of investment equal to the reserves for deferred taxes made possible by the use of accelerated depreciation. They argue that since this investment is "cost-free" to the railroads, it should not be included in the total investment on which railroads are permitted the opportunity to earn a return (Pet. 22-23).[23] The court of appeals soundly disposed of this point, however, when it observed:

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[23]The shippers have consistently ignored the fact that funds represented by deferred tax accounts are provided by the government, which defers taxation to stimulate investment, rather than the rate payers, who would pay no less if taxes were not deferred. The shippers also assert that they are not seeking to deny railroads the opportunity to earn a return on investment financed by deferred taxes, and that they did not argue below against affording railroads that opportunity. In fact, however, that would be the outcome of accepting their position, and they did so argue below. *See* Brief of Edison Electric Institute, et al. dated January 6, 1982, at 42-43 ("Utilities are not permitted to earn a return on deferred tax accounts. * * * There is no reason why the railroads should do so [sic]"); Brief of Western Coal Traffic League dated January 6, 1982, at 47 ("the Commission has reversed its position, holding that carriers should be accorded a return on deferred taxes. Obviously, this holding * * * must be set aside"). That outcome would result because under their proposal assets equivalent in amount to the deferred tax reserve would be deducted from the investment base on which a return is allowed.

> The simple fact remains * * * that for all businesses accelerated depreciation is a source of funds which may be reinvested. If the railroad industry were to be put in the position that unlike unregulated industries it could not earn a rate of return on investment of such funds it would be at a competitive disadvantage in seeking equity capital, and it would be encouraged to invest the funds generated from accelerated depreciation elsewhere than in the railroad business [Pet. App. 33a].

The shippers also cite no error in this rationale.

3. Finally, the shippers' further argument that the court of appeals' ruling on the treatment of assets equal to deferred tax revenues conflicts with decisions of three other circuits (Pet. 22-23) is not borne out by a reading of those decisions. In all three of those cases, which involved the lawfulness of particular rates and not the adequacy of overall railroad revenues, the court faulted the Commission for failing to follow its earlier policy of excluding amounts equal to the deferred tax reserve account from the investment base.[24] In this case, the court of appeals has upheld the Commission's decision to change that policy. Thus, the courts have been consistent in deferring to the

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[24]*Cleveland-Cliffs Iron Co. v. ICC*, 664 F.2d 568, 586 (6th Cir. 1981); *Iowa Public Serv. Co. v. ICC*, 643 F.2d 542, 546-47 (8th Cir. 1981); *San Antonio, Texas v. United States*, *supra*, 631 F.2d at 847. While the court in *San Antonio* stated that excluding deferred taxes from the investment base is "an essential component of an agency's election to normalize taxes for ratemaking purposes" (*id;* footnote omitted), that statement was dictum in light of the holding that the Commission had disregarded its own policy. Moreover, the authorities cited by the court suggest that it was not aware of the fundamental distinction between railroads, which operate in predominantly competitive markets, and regulated utilities, which do not. As a result of this distinction, tax incentives which may be unnecessary to encourage investment in a public utility are vital to railroads. *See* J.A. 567-68.

Commission's judgment on this issue, even as that judgment has changed, and there is no conflict.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APPENDIX

ASSOCIATION OF AMERICAN RAILROADS MEMBERSHIP LIST

Akron, Canton & Youngstown R.R.
Alton & Southern Ry.
Amtrak
Atchison, Topeka & Santa Fe Ry.
Atlanta & St. Andrews Bay Ry.
Baltimore & Ohio R.R.
Baltimore & Ohio Chicago Term. R.R.
Bangor & Aroostook R.R. Co.
Belt Ry. Company of Chicago
Bessemer & Lake Erie R.R.
Boston & Maine Corporation
Burlington Northern Railroad Co.
Canadian Pacific Ltd.
Chesapeake & Ohio Ry.
Chicago & Illinois Midland Ry.
Chicago & North Western Transportation Co.
Chicago & Western Indiana R.R.
Chicago, Milwaukee, St. Paul & Pac. R.R.
Clinchfield R.R.
Colorado & Southern Ry.
Consolidated Rail Corporation
Denver & Rio Grande Western R.R.
Detroit & Mackinac Ry.
Detroit & Toledo Shore Line R.R.
Detroit, Toledo & Ironton R.R.
Duluth, Missabe & Iron Range Ry.
Elgin, Joliet & Eastern Ry.
Fort Worth & Denver Ry.
Galveston Houston & Henderson R.R.
Georgia R.R.
Grand Trunk Lines
Green Bay & Western R.R.
Houston Belt & Terminal Ry.

Illinois Central Gulf R.R.
Kansas City Southern Ry.
Kentucky & Indiana Terminal R.R.
Lake Superior & Ishpeming R.R.
Louisiana & Arkansas Ry.
Louisville & Nashville R.R.
McCloud River R.R.
Maine Central R.R.
Manufacturers Ry.
Minneapolis, Northfield and Southern Ry., Inc.
Missouri-Kansas-Texas R.R.
Missouri Pacific R.R.
Norfolk & Western Ry.
Peoria & Pekin Union Ry.
Pittsburgh & Lake Erie R.R.
Pittsburg & Shawmut R.R.
Prescott & Northwestern R.R.
Richmond, Fredericksburg & Potomac R.R.
St. Louis Southwestern Ry.
Seabord Coast Line R.R.
Soo Line R.R.
Southern Pacific Transportation Co.
Southern Ry. Co.
Texas Mexican Ry.
Union R.R. (Pittsburgh)
Union Pacific R.R.
Vermont Ry.
Western Maryland Railway
Western Pacific R.R.
Western Railway of Alabama
Winston-Salem Southbound Ry.

CANADIAN LINES

Algoma Central Ry.
Canadian National Rys.
Canadian Pacific Limited
Ontario Northland Ry.
Toronto, Hamilton & Buffalo Ry.

MEXICAN LINES

Chihuahua-Pacific Ry.
Direccion General De Ferrocarriles En Operacion
National Railways of Mexico

No. 82-1369

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

WESTERN COAL TRAFFIC LEAGUE, THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE, AMERICAN PAPER INSTITUTE, INC., CENTRAL ILLINOIS LIGHT COMPANY, MIDDLE SOUTH UTILITIES SYSTEM, POTOMAC ELECTRIC POWER COMPANY, PUBLIC SERVICE COMPANY OF INDIANA, INC., SOUTH CAROLINA PUBLIC SERVICE AUTHORITY, NEVADA POWER COMPANY, AND AMERICAN IRON AND STEEL INSTITUTE,

Petitioners,

v.

UNITED STATES OF AMERICA AND INTERSTATE COMMERCE COMMISSION,

Respondents.

PETITIONERS' REPLY TO BRIEFS OF RESPONDENTS IN OPPOSITION TO THE PETITION FOR WRIT OF CERTIORARI

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PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D.C.

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INTRODUCTION

The Federal Respondents (the United States of America and the Interstate Commerce Commission) and the Association of American Railroads (the "Railroads") have filed briefs urging that the Petition For Writ of Certiorari be denied. These parties take the position that the Petition is not worthy of this Court's review because the issues raised are insubstantial and were correctly decided on their merits by the Court of Appeals. Petitioners file this brief in reply.

I

THE CRITICAL IMPORTANCE OF THE ISSUES RAISED BY PETITIONERS IS IGNORED BY THE RESPONDENTS

The ICC's *Ex Parte No. 393* decision holds that rail carriers are "revenue adequate" within the meaning of Section 10704(a)(2) only if their rate of return on historic net investment is equal to the current cost of capital. Using this standard as the sole measure of carrier revenue needs, the industry annually falls billions of dollars short of the sum it needs to be revenue adequate. According to the ICC's most recent pronouncements, the multi-billion dollar shortfall is to be recouped from rail traffic over which the carriers possess "market dominance," i.e. from shippers who have no competitive alternatives to rail service in moving their freight:

> [M]aximum rates on market dominant traffic, in general, should be permitted to increase to the extent necessary for a carrier to achieve revenue adequacy.[1]

Through its *Ex Parte No. 393* decision, the ICC has created a huge, phantom rail cash shortage which it proposes to have captive shippers remedy by paying massive freight rate increases on individual movements. In light of its intended consequences, *Ex Parte No. 393* is undeniably one of the most significant decisions ever issued by the Commission.

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[1] Ex Parte No. 347 (Sub No. 1), *Coal Rate Guidelines, Nationwide*, at sheet 15 (Decision served Feb. 24, 1983) (unprinted).

Despite the critical importance of *Ex Parte No. 393*, Federal Respondents attempt to downplay this case as one involving definitional semantics. (Brief at 8). Similarly, the Railroads say that the Petitioners' case rests on "economic technicalities." (Brief at 6). While Petitioners totally disagree with the Respondents' characterization, the point to be made here is that the ICC has stated its intent to use its *Ex Parte No.* 393 findings to justify wholesale rate increases on captive rail traffic. Thus, rail shippers are not presenting a petition that has only technical or semantic appeal, but are in fact presenting one which raises questions of fundamental importance to the shipping public.[2]

Respondents maintain that shippers should pursue their interests in maximum reasonable rates through individual rate

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[2] In their briefs, Respondents continually attempt to create the illusion that the Interstate Commerce Act ("Act") and the 1976 and 1980 amendments to it, are solely concerned with railroad revenue needs. However, Congress has been equally concerned with protecting the public from rate exploitation by market dominant rail carriers. In the Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31 ("4-R Act"), Congress required the ICC to take care to ensure that rail rates on captive, market dominant traffic "balance the needs of carriers, shippers and the public." *Id.* § 101(b) (uncodified). In the Staggers Rail Act of 1980, Pub. L. No. 94-448, 94 Stat. 1895 (1980) ("Staggers Act") Congress cited the need for similar balancing. *Id.* § 3 (uncodified).

Based upon the consumer protection standards that lie at the heart of the Act, both this Court and the appellate courts have consistently ruled that carrier revenue needs must be balanced against shippers' rights to be free from monopoly exploitation in determining rate reasonableness under the Act. *See, e.g., Ayrshire Collieries Corp.* v. *United States*, 335 U.S. 573, 592 (1949); *Burlington Northern, Inc.* v. *United States*, 661 F.2d 964, 973 (D.C. Cir. 1981); *Cleveland-Cliffs Iron Co.* v. *ICC*, 664 F.2d 568, 587 (6th Cir. 1981); *Iowa Public Service Co.* v. *ICC*, 643 F.2d 542, 548 (8th Cir. 1981); *Union Pacific R.R.* v. *United States*, 637 F.2d 764, 767 (10th Cir. 1981); *Celanese Chemical Co.* v. *United States*, 632 F.2d 568, 577 (5th Cir. 1981).

cases, and that therefore shippers' concerns are not worthy of consideration by this Court. Such arguments ignore reality. The existence and magnitude of the multibillion dollar carrier revenue shortfall is a direct product of the ICC's misconstruction of Section 10704(a)(2) and, if that misconstruction is not addressed here, it will continue to infect every ICC maximum ratemaking proceeding under the Act. Review by this Court is urgently required to correct this momentous and far-reaching error.

II

RESPONDENTS' ARGUMENTS DEFENDING THE ICC'S CONSEQUENTIAL "SINGLE STANDARD" INTERPRETATION OF SECTION 10704(a)(2) ARE WITHOUT MERIT

Respondents defend the ICC's construction of Section 10704(a)(2) as consistent with Congressional intent and the strictures of administrative decisionmaking set forth by this Court in *Atchison, Topeka & Santa Fe Ry.* v. *Wichita Board of Trade*, 412 U.S. 800 (1973) (*"Wichita Board"*), and related decisions. Each of these arguments is incorrect.

1. Federal Respondents admit that Section 10704(a)(2) "lists several performance tests" to be considered in determining whether a rail carrier is revenue adequate. They further concede that the legislative history of Section 10704(a)(2), as authoritatively construed by the United States Court of Appeals for the District of Columbia Circuit in *San Antonio, Texas* v. *United States*, 631 F.2d 831, 850 (D.C. Cir. 1980), "indicates that the Commission should not focus solely on rate-of-return analysis." (Brief at 13). Nevertheless, Respondents maintain that the ICC was correct to rely solely on a rate of return standard, despite the fact that "focus[ing] solely on a rate of return analysis" generates billions of capital shortfall dollars that simply do not exist when the agency carefully weighs all of the "several performance tests" set forth in Section 10704(a)(2), as it did prior to the issuance of its *Ex Parte No. 393* decision.

Respondents justify the ICC's reliance on a "single" performance test on grounds that the single standard adopted—a rate of return on a net investment base equal to the current cost of capital—generates a revenue need dollar amount that is larger than the amounts that other performance criteria produce. Accordingly, "a rate-of-return standard would assure sufficient income to meet those criteria." (Brief at 13).

Respondents' analysis, which simply parrots the position enunciated by the ICC in *Ex Parte No. 393* and deferred to by the Court of Appeals on review, ignores the fact that Congress did not want the ICC to rely solely on a rate of return standard precisely because such reliance could produce bloated revenue adequacy figures "that may have no relationship to the need for operating and capital funds necessary to maintain service in the public interest." S. Rep. No. 94-499, 94th Cong. 2d Sess. 52 (1975). Congress intended for the ICC to weigh all the performance criteria and to reach reasoned results, "as opposed to [setting] a theoretically adequate rate of return on investment." *Id.*

2. Consistent with the Congressional intent underlying Section 10704(a)(2), the ICC ruled in its first two implementing decisions under Section 10704(a)(2) that Congress "does not envision that the rate of return will be the sole factor to be considered in judging carrier revenue adequacy." Ex Parte No. 338, *Standards and Procedures for the Establishment of Adequate Revenue Levels*, 358 I.C.C. 844, 904 (1978); Ex Parte No. 353, *Adequacy of Railroad Revenue (1978 Determination)*, 362 I.C.C. 198, 216 (1979). In direct contravention of the principles enunciated by the Court in *Wichita Board*, the Commission's *Ex Parte No. 393* decision never addresses or explains its change of statutory interpretation.

Respondents argue that the Commission did not run afoul of *Wichita Board* because the ICC did provide the required explanation, in a passage of the *Ex Parte No. 393* decision which states that the ICC's "adoption of a rate of return standard is not a radical departure from our previous standards[]" because

"[i]n adopting such a standard here, we are only adapting our earlier findings to the mandate and policy of the [Staggers] Rail Act." (Federal Respondents' Brief at 14, quoting *Ex Parte No. 353, supra*).

The purported "explanation" by Respondents is no explanation at all. In fact, the passage cited by Respondents was not inserted by the ICC to address its previous statutory construction, but to ignore it by claiming there was no "radical departure" from its past standards. Of course, the agency's characterization is wrong. Under its pre-*Ex Parte No. 393* standards, where the agency looked to all relevant financial evidence, the ICC found that 13 of 31 major railroads in the United States were "revenue adequate." In contrast, when the ICC relied solely on its rate of return standard in *Ex Parte No. 393*, all but three roads were declared revenue inadequate and the revenue shortfall of the industry, as a whole, reached the astoundingly high level it stands at today. (Using post-*Ex Parte No. 393* capital costs, *no* roads are revenue adequate.) Thus, a "radical change" did, in fact, take place even though during this same time period the financial health of the rail industry actually improved.

Similarly, the Commission's cryptic reference to the Staggers Act does not supply the reasoned basis required under *Wichita Board* for its new statutory interpretation. In the Staggers Act, the Congress left the definition of revenue adequacy unchanged.[3] Nothing in the Staggers Act, or its legislative history, supports the ICC's new construction of

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[3] While leaving the definition of carrier revenue adequacy unchanged, Congress codified the ICC's pre-Staggers Act practice of considering revenue adequacy in rate reasonableness cases (*id.* §§ 201(a), 203(a), *codified in pertinent part* at 49 U.S.C. §§ 10701(a)(b)(3), 10707a(d)), ordered the ICC to finish its incomplete revenue adequacy proceedings (Staggers Act § 205, codified at 49 U.S.C. § 10704(a)(3) and (4)), and inserted a clause in the statute authorizing the ICC to "revise as necessary" its then-current reve-

10704(a)(2). Indeed, while Congress made numerous changes in other sections of the Act, its decision not to change Section 10704(a)(2), as administered by the ICC prior to the Staggers Act, provides compelling proof that Congress accepted and adopted the ICC's initial reading. *Cf. Goldsboro Christian Schools, Inc.* v. *United States*, ___ U.S. ___, No. 81-1 (S.Ct. May 24, 1983) (slip op.).

III

RESPONDENTS' OTHER ARGUMENTS UNDERSCORE THE PLIGHT OF THE NATION'S CAPTIVE RAIL SHIPPERS AND THE NEED FOR REVIEW BY THIS COURT

In its *Ex Parte No. 393* decision, the ICC further compounded its error in adopting a rate base/rate of return standard by designing a standard whose only apparent justification is that it creates an enormous revenue shortfall for the nation's railroads, which then can be "recouped" from captive rail shippers. This is the only logical answer to the agency's cavalier

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nue adequacy regulations. Staggers Act § 205, *codified in pertinent part* at 49 U.S.C. § 10704(a)(2). None of these provisions provides any support whatsoever for the ICC's actions in *Ex Parte No. 393*.

Respondents, citing isolated passages from the legislative history of the Staggers Act, argue that Congress rejected the ICC's pre-Staggers Act interpretation of Section 10704(a)(2) and legislated a "strengthened mandate." (Railroads' Brief at 5). The fact of the matter is that Congress did not change the definition of carrier revenue adequacy. Moreover, any doubt as to the intent of Congress in this regard was clarified by Congressman Eckhardt, a member of the Conference Committee on the Staggers Act, who stated for the record:

> [A]ny suggestion that the conferees intended that the Commission must change its [revenue adequacy] standards from what they are today . . . is unfounded. Clearly, there is nothing in the conference bill or report expressing such a purpose or intent.

126 Cong. Rec. E-4857 (Oct. 15, 1980).

treatment of the three key issues concerning its rate base/rate of return methodology. Respondents' arguments in support of the Court of Appeals' affirmance of the ICC's resolution of these issues do not support a different conclusion.

1. Respondents defend the ICC's decision not to exclude unused and nonuseful assets from carrier rate bases on grounds that such assets are "insubstantial." Yet the carriers' own evidence, which evaluated but one small portion of the carriers' rate base, found, as Respondents concede, "$225 million in unused and unuseful property." (Federal Respondents' Brief at 16). Respondents' claims that the ICC will "eliminate unused and unuseful assets from the investment base" (*id.*) ring hollow when the agency refuses to deduct property identified by the industry itself as unused and nonuseful. Nor can self-serving promises made by the Federal Respondents that the ICC will consider the used and useful question in other proceedings "moot" the ICC's error in ignoring the issue in the present case.[4]

2. Respondents argue the ICC correctly ruled that deferred taxes should be included in the carriers' rate bases. Three

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[4] The Federal Respondents refer to the ICC's March 9, 1983 decision Ex Parte No. 393 (Sub No. 1), *Standards for Railroad Revenue Adequacy* (unprinted) as a proceeding wherein the ICC proposes to take another look at the "used and useful" question. There, the ICC states that "it is particularly important to ensure that assets that are not 'used and useful' are not included in the investment base . . . ." *Id.* at 10. Obviously, the ICC's failure to heed this standard was material error in the proceedings below.

Federal Respondents also argue that the ICC had insufficient time in the proceedings below to identify and remove unused and nonuseful assets. (Brief at 16). This is frivolous in light of the fact that the ICC was under no mandate to place sole reliance on the rate base/rate of return standard. At the very least, the ICC had to "eliminate unused and unuseful assets from our calculation" (*Ex Parte No. 393*, 364 I.C.C. at 811 (App. to Cert. Petn. 9b)) *prior* to its use of this standard.

circuits correctly disagree, however, on grounds that deferred taxes constitute revenues contributed by shippers to carriers at no capital cost, and shippers should not be required to pay carriers a return on no-cost capital. *San Antonio, Texas* v. *United States*, 631 F.2d 831, 847 (D.C. Cir., 1980) *("San Antonio"); Iowa Public Service Company* v. *ICC*, 643 F.2d 542, 546-547 (8th Cir., 1981); *Cleveland-Cliffs Iron Co.* v. *ICC*, 664 F.2d 568, 586 (6th Cir., 1981).

Respondents maintain that these cases are distinguishable because the courts, in reaching their holdings on the deferred tax issue, were simply deferring to the Commission's revenue adequacy regulations which, at the time the decisions were issued, did not permit a return on deferred taxes. Respondents misread the precedents. In the first railroad rate case to consider the deferred tax issue, the D.C. Circuit read Section 10704(a)(2) in light of basic principles of public utility ratemaking which require ratemaking authorities to exclude deferred tax accounts from the rate bases of regulated industries. "Otherwise the rate payer . . . would be paying the carriers for earnings on the tax differential even though it was the rate payer who contributed the differential in the first place." (*San Antonio*, 631 F.2d at 847). In *San Antonio*, the D.C. Circuit noted that the ICC's then-current regulations were consistent with this reading of the law. Its deferred tax ruling was rooted in the statute, not in the ICC's implementing regulations. The *San Antonio* holding has been followed by both the Sixth and Eighth Circuits. The conflict between these court holdings and the contrary result reached in the proceedings below by the Third Circuit can only be resolved by review proceedings before this Court.

3. The ICC arbitrarily and capriciously concluded in *Ex Parte No. 393* that all carrier debt costs should be treated as if they were incurred at the current cost of debt, even though substantial portions of current carrier debt was issued in past years at fixed interest rates that are far below present day levels. The effect of this decision is to grossly overstate the interest costs that rail carriers need to cover in order to enjoy "adequate" revenues.

Federal Respondents maintain that this action "was a rational response to the general problem of properly accounting for inflation." (Brief at 19). However, the point is that fixed interest rates are not subject to inflation. If, for example, money was borrowed in 1968 at a fixed interest rate of 6% over a twenty year term, the fact that the 1983 interest rate on new debt has, due to inflation, risen to 12% is irrelevant because the interest rate paid by the carriers on the 1968 debt is still 6%.

Respondent Railroads argue that using actual debt costs in calculating the cost of capital somehow means that rail carrier earnings "may not exceed a level sufficient to cover the embedded cost of debt." (Brief at 13). Petitioners are saying no such thing. The cost of capital contains an equity and debt component. Properly calculating carrier debt costs does not affect the equity component, and the resulting cost of capital (i.e. debt plus equity) necessarily reflects the higher equity capital costs. Moreover, the actual cost of debt, properly calculated, would reflect and weigh the cost of current debt issuances, along with historical debt, in arriving at the actual cost of debt. Treating all debt as currently issued, however, creates interest expenses which were simply not incurred by the rail industry.

* * *

The combined effect of the identified errors in the ICC's rate methodology for the debt and deferred tax issues alone generates, at the very least, a $835,000,000 overstatement of the carriers' annual revenue shortfall. (Petitioners Brief at 21-24).

CONCLUSION

Respondents' arguments that this Court should not issue a writ of certiorari are without merit. For the reasons cited here

and in the Petition, certiorari should be granted and the case set for briefing and oral argument.

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No. 82-1369

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

WESTERN COAL TRAFFIC LEAGUE, THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE, AMERICAN PAPER INSTITUTE, INC., CENTRAL ILLINOIS LIGHT COMPANY, MIDDLE SOUTH UTILITIES SYSTEM, POTOMAC ELECTRIC POWER COMPANY, PUBLIC SERVICE COMPANY OF INDIANA, INC., SOUTH CAROLINA PUBLIC SERVICE AUTHORITY, NEVADA POWER COMPANY, AND AMERICAN IRON AND STEEL INSTITUTE, *Petitioners*,

v.

UNITED STATES OF AMERICA AND INTERSTATE COMMERCE COMMISSION, *Respondents*.

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND BRIEF OF THE CONSUMER OWNED POWER COALITION AS AMICUS CURIAE IN SUPPORT OF THE PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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Dated: March 18, 1983

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MOTION OF THE CONSUMER OWNED POWER COALITION FOR LEAVE TO FILE BRIEF AMICUS CURIAE

The Consumer Owned Power Coalition ("COPC") respectfully moves this Court, pursuant to Rules 36 and 42 of its Rules, for leave to file the accompanying brief amicus curiae in support of the petition for writ of certiorari filed in the above captioned matter. In accordance with the Court's rules, the consent of the parties to the filing of the attached brief was sought. All of the petitioners and the respondent Interstate Commerce Commission gave their consent. However, the Association of American Railroads refused such consent.

As set out in the statement of Identity and Interest of Amicus, COPC is an organization speaking for thousands

of consumer-owned utilities throughout the nation. These utilities are vitally concerned with the proper interpretation and application of the Revised Interstate Commerce Act in order to protect coal shippers who are captive to the railroads from the imposition of unreasonable freight rates. COPC seeks permission to file its brief amicus curiae because of its belief that the decisions of the court below and of the Interstate Commerce Commission badly misinterpreted the Revised Interstate Commerce Act in a fashion which would serve to authorize billions of dollars of unjustified increases in rail rates for captive coal traffic whose payment will ultimately be borne by electric utility customers. COPC participated in

the proceedings below as an amicus curiae.

In its brief, amicus addresses two major decisions issued by the Interstate Commerce Commission, after the petition for writ of certiorari in this proceeding was filed, which confirm the devastating impact on captive coal shippers of the Commission's decision affirmed by the court below.

Respectfully submitted,

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THE NATIONAL INDUSTRIAL TRANSPORTATION
LEAGUE, AMERICAN PAPER INSTITUTE, INC.,
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MIDDLE SOUTH UTILITIES SYSTEM,
POTOMAC ELECTRIC POWER COMPANY,
PUBLIC SERVICE COMPANY OF INDIANA,
INC., SOUTH CAROLINA PUBLIC SERVICE
AUTHORITY, NEVADA POWER COMPANY, AND
AMERICAN IRON AND STEEL INSTITUTE,
Petitioners,

v.

UNITED STATES OF AMERICA AND INTERSTATE
COMMERCE COMMISSION,
Respondents.

BRIEF OF THE CONSUMER OWNED POWER COALITION AS AMICUS CURIAE IN SUPPORT OF THE PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

IDENTITY AND INTEREST OF AMICUS

COPC is an organization comprised of six power service organizations representing thousands of consumer-owned public utilities, and eighteen individual consumer-owned utilities and joint action power agencies. It was formed in 1980 to represent the interests of its members in the several major rulemaking proceedings initiated by the Interstate Commerce Commission ("Commission" or "ICC") in order to implement the provisions of the Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895 (1980).

The members of COPC are the American Public Power Association; National Rural Electric Cooperative Association; Western Fuels Inc.; Committee on Power for the Southwest; Mid-West

Electric Consumers Association; Municipal Electric System of Oklahoma; Alabama Electric Cooperative, Inc.; Salt River Project; Jonesboro, Arkansas, City Water and Light; Platte River Power Authority; Gainesville Regional Utilities/City of Gainesville, Florida; Jacksonville, Florida, Electric Authority; Orlando, Florida, Utilities Commission; Municipal Electric Authority of Georgia; East Kentucky Power Cooperative, Inc.; Louisiana Energy and Power Authority; Grand Haven, Michigan, Board of Light and Power; Holland, Michigan, Board of Public Works; Michigan Public Power Agency; Michigan South Central Power Agency; Traverse City (Michigan) Light and Power; Hibbing, Minnesota, Public Utilities Commission; Virginia, Minnesota, Department of Public Util-

ities; South Mississippi Electric Power Association; City Utilities of Springfield, Missouri; Grand Island, Nebraska, Electric Department; Hastings, Nebraska, Utilities; Nebraska Public Power District; Western Farmers Electric Cooperative; Intermountain Power Agency; and Dairyland Power Cooperative.

The individual utility members of COPC depend, to varying degrees, upon coal to fuel their power generation facilities. For most of these facilities, the utilities involved are captive to specific rail carriers for the transportation services required to move their coals from the mine to the power plant. Typically, the utility is committed to purchase coal from the specific mine under long-term contract; the mine is only served by one railroad; and the

utility's plant is only served by one railroad. As a result, the rail carriers involved face no intramodal competition from other railroads and the distances and volumes involved rule out motor transport. Under these circumstances of captivity, which prevail for a large percentage of coal-fired utility plants, the railroads possess broad monopoly pricing power which can only be moderated through the maximum rate regulation authority granted to the Interstate Commerce Commission by the Revised Interstate Commerce Act ("Act"), 49 U.S.C. §10101a, et seq.[1]

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[1] Where a utility is fortunate enough to have competitive alternatives for coal transportation available to it, there is no ICC maximum rate regulation jurisdiction (see, 49 U.S.C. § 10709) because it is assumed that market forces can be relied upon to restrain rail rates to reasonable levels.

Under the Act, the Commission is called upon to balance carriers' needs for revenues against captive shippers' needs for reasonable rates in exercising its regulatory jurisdiction.[2] Through the agency's actions in Ex Parte No. 393, Standards for Railroad Revenue Adequacy, 364 I.C.C. 803 (1981) ("Ex Parte No. 393") (App. to Cert. Petn. B) the Commission has adopted a standard for determining carrier revenue adequacy that grossly overstates the amounts of money carriers need to be "revenue adequate" as that term is defined in the statute (at 49 U.S.C. § 10704(a)(2)) and, through this error,

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[2] See, e.g., Burlington Northern, Inc. v. United States, 661 F.2d 964, 973-74 (D.C. Cir. 1981); Cleveland-Cliffs Iron Co. v. ICC, 664 F.2d 568, 587 (6th Cir. 1981).

has destroyed the careful balance incorporated by Congress into the Act. The Court of Appeals erred in affirming the ICC's action.

COPC members are among the captive rail shippers to whom the railroads turn to obtain the rate increases they need in order to satisfy their revenue needs as measured by the ICC's new standards. For this reason, COPC members are directly and vitally concerned with the issues raised by the petition for a writ of certiorari filed by the Western Coal Traffic League, et al. Because of the importance of the issues involved to its members and the electric consumers which they serve, COPC participated in the proceeding before the court below as an Amicus Curiae.

REASONS FOR GRANTING THE WRIT

I.

THE ISSUES PRESENTED BY THIS CASE WARRANT THIS COURT'S REVIEW

This case presents two critically important legal questions. Those questions are:

-- Whether the Court of Appeals erred in affirming the ICC's interpretation of 49 U.S.C. § 10704(a)(2), the "revenue adequacy" section of the Act, as permitting the Commission to rely on a single standard -- a rate of return on the carrier's net investment base equal to the current cost of capital -- as the sole

measure for determining carrier revenue adequacy; and

-- Whether the Court of Appeals erred in upholding the ICC's subsidiary findings concerning the composition of its rate base/rate of return standard.

A. The Statute Does Not Permit Reliance On A Single Standard.

Section 10704(a)(2) of the Act, introduced into the law in Section 205 of the Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 92 Stat. 31 (1976) ("4-R Act") calls upon the ICC to consider various financial criteria in determining whether a rail carrier is financially healthy, or, in the words of the

Act "revenue adequate." Consistent with the plain meaning of the statute, the Commission, for several years, interpreted Section 10704(a)(2) as requiring the agency to look to all available indicators of financial health, and, after evaluating all relevant evidence, to make a reasoned finding as to which carriers were or were not revenue adequate. Ex Parte No. 353, Adequacy of Railroad Revenue (1978 Determination), 362 I.C.C. 198 (1979); Ex Parte No. 338, Standards and Procedures for the Establishment of Adequate Revenue Levels, 358 I.C.C. 844, modified, 359 I.C.C. 270 (1978). Based upon a consideration of all indicia of financial health, the ICC ruled in 1980 that thirteen of the thirty-six major railroads in the United States were "revenue adequate." Ex

Parte No. 353, supra, 362 I.C.C. at 256-57.

In its Ex Parte No. 393 decision, affirmed by the court below, the Commission made an abrupt about-face, deciding that the statutory definition of revenue adequacy (which has not been changed) did not, after all, require it to take an informed look at all financial indicators. The Commission ruled that it would look solely to one test of carrier revenue adequacy -- whether a railroad is earning a current cost of capital return on its net investment base. If a railroad is not earning such a return, the Commission classifies it as revenue inadequate. Using this single factor test, not one of the nation's major railroads is revenue adequate. The estimated revenue short-

fall under the new standard, i.e., the difference between the sums of money major rail carriers are now earning and the amount they need to obtain "revenue a equacy," amounts to several billion dollars per year.[3]

Congress did not intend for the ICC to focus blindly on a rate of return standard as the sole measure of carrier revenue adequacy. Indeed, as is emphasized in the Congressional reports accompanying the enactment of Section 10704(a)(2), Congress warned the ICC to avoid reliance on "a theoretically adequate rate of return on investment ...."[4] The Congress intended that

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3 See Ex Parte No. 393, supra, 364 I.C.C. at 818 (App. to Cert. Petn. 16b).

4 See Rail Services Act of 1975, Report of the Senate Committee on Commerce On S.2718, S. Rep. No. 94-499, 94th Cong., (Continued)

revenue adequacy be a meaningful standard to separate strong and weak railroads. Under the standard adopted by the Commission in Ex Parte No. 393, it is not. Review by this court is absolutely essential for the preservation of the integrity of the Act and the protection of captive rail shippers.

B. The Court Below Erred In Affirming The ICC's Subsidiary Rulings.

The Court of Appeals also erred in upholding the ICC's decisions not to exclude unused and nonuseful assets, or deferred tax reserves, from the carriers' rate bases, and to calculate the current cost of capital by treating all carrier debt as if it were purchased at current interest rates. These errors serve to artificially

2d Sess. 51-52 (1975).

inflate both the rate base and the target rate of return by astronomical sums. Congress did not intend, and Section 10704(a)(2) does not permit, the ICC to inflate either the carriers' rate bases or their cost of capital through adoption of standards that ignore basic precepts of regulation.

It is one of the most fundamental rules of regulation that regulated entities are not entitled to a return on assets which are not used and useful in the enterprise. This rule has been consistently recognized by the courts. Similarly, three U.S. Courts of Appeals have ruled that deferred tax reserves must be subtracted from rail carriers' rate bases for regulatory

purposes.[5] Thus, there is a clear and obvious conflict between the results of these three circuit court decisions and that reached by the court below. Finally, it strains credulity for the ICC to engage in the fiction that in order to attain "adequate" revenues all carrier debt expense must be viewed as incurred at the current cost of debt, when, in fact, a great majority of that debt was issued at fixed rates which are far below current debt costs. It should be noted that the statute speaks of "a flow of net income ... adequate to ... assure repayment" of debt. This clearly

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[5] San Antonio, Texas v. United States, 631 F.2d 831, 847 (D.C. Cir. 1980); Iowa Public Service Co. v. ICC, 643 F.2d 542, 546-547 (8th Cir. 1981); and Cleveland-Cliffs Iron Co. v. ICC, 664 F.2d at 586.

contemplates sufficient income to pay the actual debt cost.

Analysis of the Court of Appeals' decision reveals that the lower court simply, and erroneously, rubber stamped the ICC's treatment of the two critical issues in this case. Review by this Court is necessary to correct these errors, to resolve the conflict among the circuits and to construe Section 10704(a)(2) as intended by Congress so that it can play its proper role in the regulatory scheme in the Revised Interstate Commerce Act. Moreover, as explained, infra, review is needed because of the severe practical consequences which the ICC's Ex Parte No. 393 decision entails for the shipping public.

II.

THE FINANCIAL CONSEQUENCES OF THE ISSUES RAISED ARE OF MAJOR DIMENSIONS AND WILL BE DIRECTLY SHOULDERED BY THE NATION'S ELECTRIC UTILITY RATEPAYERS

In a very real sense, amicus appears before this Court more in the role of spokesman for the ratepayers of their member companies than for the members themselves. In many parts of the country increases in the cost of fuel, which ordinarily includes the cost of transportation required to deliver the fuel, are passed by the utilities directly through to the consuming public, subject to regulatory scrutiny, by mechanisms which can generally be described as fuel adjustment pass-throughs. By operation of fuel cost adjustment pass-throughs, the burden of increases in coal freight rates is felt

immediately, and with full force, by the consumer. Amicus and its constituent members have been and will continue to be vigilant to protect their ratepayers from unjustified increases in the cost of fuels and, in this case, in the cost of transporting the coal required for coal-fired power generating facilities.

Through the decision under review, the ICC has created a staggering multi-billion dollar annual "revenue shortfall" which the railroad industry will attempt to recoup from captive traffic. The principal captive traffic over which the railroads possess monopoly power is coal, and, to a very large degree, the railroads will attempt to obtain this vastly overstated revenue

shortfall from the electric utility industry.

The tremendous impact which the Commission's new standards will have on coal freight rates is confirmed beyond any legitimate dispute in a major decision served by the ICC some ten days after the Petition for Writ of Certiorari was filed in this case. In that decision, Ex Parte No. 347 (Sub No. 1), Coal Rate Guidelines, -- Nationwide (served February 24, 1983)(unprinted), the Commission has proposed standards for directly linking up its Ex Parte No. 393 revenue adequacy findings to attainment of those revenues solely from captive coal traffic. Therein, the Commission adopts the position that, as a general proposition, "maximum rates on market dominant traffic ... should be

permitted to increase to the extent necessary for a carrier to achieve revenue adequacy." Id. at sheet 15.

The basic ratemaking policy proposed by the Commission is that the railroads should be permitted to price their services on the base of demand considerations, i.e., "whatever the traffic will bear," subject only to four "constraints" only one of which, in fact, appears to constitute any practical constraint. The principal "constraint" according to the Commission is what it describes as "stand-alone cost" which is defined at sheet 11 as:

> the cost of serving that shipper alone, as if it were isolated from the railroads other customers. It represents that level at which the shipper could provide the service itself.

Id. (footnote omitted). The Commission recognizes that "carriers with inadequate revenues could raise coal rates dramatically in the markets they dominate under [these] pricing constraints ...." Id. at sheet 16. In order to "protect" captive coal shippers from abrupt imposition of what it describes as the "dramatic increases on captive coal traffic" which its new stand-alone cost ratemaking standard would permit, the Commission proposes to "limit" increases to fifteen percent (15%) per year over and above inflation.[6] Id.

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6 Increases of fifteen percent (15%) per year or less will be presumed to be reasonable and if not taken in one year will be allowed to carry over to subsequent years. Id. at sheet 16, n.46. Compare this proposal to the zone of rate flexibility established by Congress of six percent (6%) per year from 1980 to 1984 and four percent (4%) per year thereafter (with no presumption of rea-
(Continued)

The Commission explains that it selected this fifteen percent (15%) "phase-in" (which would double existing freight rates in five (5) years even before guaranteed inflation increases are factored in) because if the rates on all coal traffic are increased each year by this amount, 19 out of 21 major coal hauling railroads could achieve within eight years the revenue adequacy measure defined in Ex Parte No. 393 and approved by the court below. Id. at sheet 18, n.51. Due to the direct tie-in which the Commission has established between captive coal rates and achievement of revenue adequacy, it is of the utmost importance to the electric ratepayers of this nation that this Court assert its

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sonableness) 49 U.S.C. § 10707a(c), (d), (e).

jurisdiction to review the Court of Appeals' decision. The grossly overstated level of earnings which are required to achieve "adequate revenues" as determined under the misguided and statutory indefensible standard adopted by the Commission in Ex Parte No. 393 will translate directly into the unjustified transfer of billions of dollars from the pocketbooks of electric utility ratepayers to rail carrier shareholders.[7]

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[7] The overstatement of earnings needed to attain revenue adequacy occasioned by the Commission's Ex Parte No. 393 standards will be exacerbated by the Commission's decision in Ex Parte No. 347 (Sub No. 1) to convert from an original cost investment base to an inflation-adjusted replacement value investment base. In order to effectuate this conversion, the Commission has just initiated Ex Parte No. 393 (Sub No. 1), Standards For Railroad Revenue Adequacy (served March 9, 1983)(unprinted) in order "to improve the standards adopted in Ex Parte No.
(Continued)

Electric utilities and their ratepayers already face staggering financial demands for the capital outlays which they are required to make in constructing new coal-fired facilities. Adding to that burden exorbitant coal rate increases, which are predicated upon an inflated and artificial view of the financial needs of the railroad industry, is a wrong that this Court should not permit.

III.

VITAL CONSUMER AND ENERGY ISSUES AFFECTING THE ENTIRE NATION ARE AT STAKE

The Commission applies its revenue adequacy findings in virtually all its rail ratemaking functions under

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393" (*id.* at 1) by developing the replacement cost valuation methodology and certain related procedures.

the Act, including its decisions whether to suspend or investigate new rates (49 U.S.C. §10707a) and in determining the maximum lawfulness of both new and existing rates (49 U.S.C. §10701a(b)). As described above, the ICC has proposed in Ex Parte No. 347 (Sub-No. 1) to permit a multi-billion dollar transfer of funds from captive rail shippers to rail carrier shareholders. Obviously, the Commission's action raises very basic consumer protection issues, since it is the consumer of electric power at the meter, i.e. the general public, that will directly bear these high rail rates. This Court has long recognized that consumer interests must be protected by the ICC in carrying out its duties under the Act. As stated by the Court in Ayrshire Collieries Corp. v.

United States, 335 U.S. 573, 592 (1949):

> Rate structures are not designed merely to favor the revenues of producers and carriers. The Commission has the consumer interest to safeguard as well.

Id. It is clear that in both the 4-R Act of 1976 and the Staggers Rail Act of 1980, Congress intended to preserve maximum ratemaking jurisdiction over captive traffic in order to protect the public in general, and particularly utility coal shippers,[8] from the imposition of unreasonable rates. Through its decision, the Court of Appeals has affirmed an ICC action that is now being used to write consumer protection right out of the Act. This is a

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[8] See Report of the Committee On Conference On the Staggers Rail Act of 1980, H.R. Rep. No. 96-1430, 96th Cong., 2d Sess. 80 (1980).

disastrous turn of events justifying intervention by this Court.

Moreover, it has been acknowledged time and time again that excessively high coal rates conflict with the national energy policy calling for the increased use of coal as a boiler fuel. See, e.g., Celanese Chemical Co. v. United States, 632 F.2d 568, 579 (5th Cir. 1980), cert denied, 453 U.S. 950 (1981); Iowa Public Service Co. v. ICC, 643 F.2d at 548.[9] The delivered cost of

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[9] Numerous laws have been enacted in recent years calling for major users of fuel to decrease our country's dependence on imported oil and natural gas through substitution of domestically mined coal, wherever feasible. See Emergency Petroleum Allocation Act of 1973, Pub. L. No. 93-511, 88 Stat. 1608 (1974); Federal Nonnuclear Energy Research and Development Act of 1974, Pub. L. No. 93-577, 88 Stat. 1878 (1974); Energy Reorganization Act of 1974, Pub. L. No. 94-438, 88 Stat. 1233 (1974); Energy Supply and Environmental (Continued)

coal fuel has a major influence upon the economic feasibility of new coal-fired power generating facilities. The price of rail transportation is, in turn, a major element of the delivered price of coal -- frequently far exceeding the mine mouth price of the coal itself. At this time in our nation's history, when coal is asked to play such a major role in our campaign for energy self-sufficiency, it is clear that coal shippers should not be saddled with exorbitant rates, based upon the ICC's miscontruction of its statutory mandate.

Coordination Act of 1974, Pub. L. No. 93-319, 88 Stat. 246 (1974); Energy Policy and Conservation Act, Pub. L. No. 94-163, 89 Stat. 871 (1975); Energy Conservation and Production Act, Pub. L. No. 94-385, 90 Stat. 1125 (1976); Powerplant and Industrial Fuel Use Act, Pub. L. No. 95-620, 92 Stat. 3289 (1978).

CONCLUSION

The importance of the issues raised by the Petition for Writ of Certiorari and the magnitude of the financial consequences entailed in the resolution of these issues warrant the issuance by this Court of a writ of certiorari.

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